Submission No 234

INQUIRY INTO ELECTRICITY SUPPLY, DEMAND AND PRICES IN NEW SOUTH WALES

Organisation: ERM Power

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The Hon. Paul Green
Chair
Legislative Council Select Committee on Electricity Supply, Demand and Prices in New South Wales
Parliament of New South Wales
Macquarie St
Sydney NSW 2000

Dear Mr Green

RE: Select Committee on electricity supply, demand and prices in New South Wales

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Legislative Council Select Committee on electricity supply, demand and prices in New South Wales (the Committee).

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load[1], with operations in every state and the Australian Capital Territory. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. ERM Power also sells electricity in several markets in the United States. The Company operates 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland. www.ermpower.com.au

General Comments

Large energy users constitute about 60 per cent of electricity consumption in Australia. The sector is critical to jobs and the nation's economic prosperity and it's in all of our best interests to find ways to help them reduce costs and grow their businesses. As the Committee will no doubt have found in its research so far, the residential electricity market is significantly different to that of the commercial and industrial (C&I) market in terms of the way electricity is contracted. It is also vastly different in relation to the margin earnt by residential retailers versus commercial and industrial retailers, with significantly higher margins in residential retailing.

ERM Power brought competition to the C&I market and has championed solutions to reduce electricity consumption and cost reductions for business. This is evident in our modest margin and in our customer satisfaction which is the highest of any retailer (six years in a row) and this year, was the

[1] Based on ERM Power analysis of latest published financial information.

highest customer satisfaction score in the 21-year history of the UMI survey.[2] We would not record these outstanding levels of customer satisfaction at a time when prices have been rising, if we did not have the customer's best interests at heart.

ERM Power encourages a close examination of the drivers of electricity price increases in New South Wales, and elsewhere in the National Electricity Market (NEM) over the past several years. We have seen that a number of factors have led to increases in both wholesale and retail electricity prices. While we do not believe that there are easy solutions, there are certainly improvements that can be made.

On the whole, ERM Power believes that competition and deregulation has brought benefits to both the wholesale and retail segments of energy markets. Provided that competitors can operate on a level playing field and that new competitors are able to enter the market, competition should continue to benefit consumers in the long term. That is not to say that energy markets are working perfectly at present. There are definite improvements that can be made that would ultimately improve outcomes for consumers.

As NSW and Australia adjust to new technologies, care must be taken to ensure that a new policy framework to reduce emissions and secure reliable and affordable supplies of electricity will ultimately benefit all consumers. The proposed National Energy Guarantee (NEG) will have to be carefully designed and closely monitored as it poses a very different market structure, one which, on the outset, tips the balance of power further in favour of the existing, dominant generators, and even more so to those which are vertically integrated (gentailers). We believe the members of the NSW Parliament, across the political spectrum, can play a significant role in designing the NEG to avoid detrimental outcomes for consumers.

The submission which follows outlines ERM Power's views on each of the three parts of the electricity supply chain – generation, networks and retail – as well as discussing the impact of policy uncertainty.

I welcome the opportunity to discuss this submission in detail. Alternatively, please contact Regulatory Affairs Policy Advisor Ben Pryor

Yours sincerely,

Jon Stretch

Managing Director and CEO
ERM Power Limited

[2] Customer satisfaction refers to the Utility Market Intelligence (UMI) surveys 2011-2016 of large customers of major electricity retailers in Australia, undertaken by independent research company NTF Group

Wholesale markets

There is no simple way to explain the sharp rise in electricity prices over recent years. A range of impacts are responsible in some way, some of which can be traced back to decisions made a decade or more ago. There are drivers pushing up end-user electricity prices in all parts of the supply chain: generators, transmission and distribution networks and retailers. Unfortunately there is no quick and simple solution to this. Bringing power prices down will take time and require sensible, consistent and considered decision-making at both state and federal levels.

On generation, the wholesale market prices increases over the past 12 months certainly appears shocking. There are, as has been explored by the Australian Competition and Consumer Commission (ACCC) and others, a range of reasons for this increase including the closure of Hazelwood and Northern Power Stations and higher gas prices. As NSW has tended to import power from Victoria, the tighter supply-demand balance in Victoria following Hazelwood's closure translates through to less supply being available to transport power from Victoria to NSW, and consequently, higher prices in NSW.

Similarly, due to the reduction in low-cost coal-fired generation capacity, gas is becoming the marginal fuel source more frequently. With high gas prices due to tight domestic supply, this results in higher wholesale prices. It is also important to remember that these rises have come after a long period of historically low wholesale prices, driven by an oversupply of capacity in the wholesale market coupled with falling demand. Neither of these situations would be sustainable over the long term.

Increased competition in the wholesale market is crucial to improving outcomes for consumers over the longer term. In NSW, the three large vertically-integrated gentailers – AGL, Origin Energy and Energy Australia – account for more than 80 per cent of electricity generation.[3] This is a scenario played out in other NEM states where the combined market shares of the two or three most significant generators exceeds 70 per cent on both capacity and dispatched energy measures.

We wish to draw the Committee's attention to the falling liquidity in the contract market over the past few years. Retailers (and generators) rely on contract markets to hedge risk in the wholesale market. When liquidity tightens, retailers either face higher prices to hedge, or may choose to hedge less, which translates to a higher risk profile. A higher risk profile requires higher returns. In either case, a reduction in contract market liquidity will lead to higher prices for end users. An improvement in contract market liquidity is therefore crucial to helping reduce retail electricity prices.

Over the past few years, there has been significant new supply enter into the NEM, but this has predominantly been wind and solar PV, which are unable to offer hedge contracts to the market. Furthermore the exit of plant such as Northern and Hazelwood power plants has prompted a further reduction in contract market liquidity.

The high degree of vertical integration in the NEM may be another driver of the reduction in contract market liquidity. In ERM Power's view, care should therefore be taken to avoid policy responses that further enhance the market power of large, vertically-integrated gentailers, which could further reduce contract market liquidity. Policies such as the AEMC's Five Minute Settlement rule change, which will come into effect on 1 July 2021 may have the unintended outcome of further enhancing the market

[3] ACCC, *Retail Electricity Pricing Inquiry – preliminary report*, October 2017, p80 and 103.

power of large, vertically-integrated energy business rather than increasing competition. This could lead to higher prices for consumers in the long run.

This situation certainly has the potential to threaten competition in the retail market by these dominant players not offering sufficient hedging contracts at competitive terms. In the case of Queensland, the two largest generators are government-owned; the Queensland Government's recent decision to direct one of their generators to lower their pricing has had flow on impacts to private generators in the market.

The ACCC's Preliminary report into retail electricity price indicates that it will investigate options to address the concentration of market power in the wholesale market through options such as unwinding previous consolidation of generation assets, constraining further consolidation of ownership of existing generation assets and improving the availability and affordability of gas. A genuine increase in competition and associated increase in contract market liquidity should help to reduce wholesale electricity prices efficiently over the longer term, with overall benefits to consumers. ERM Power encourages the Committee to explore options that will help to increase competition in the generation market.

Policy uncertainty

One of the other major factors affecting wholesale electricity prices is the policy uncertainty around climate change and the energy market. The failure of Australia to find a consistent, national approach to reducing emissions and the uncertainty driven by this lack of policy is preventing any meaningful new entry into the energy market. Renewable energy has gained some revenue certainty through the Renewable Energy Target, but with this due to peak in 2020, this is unlikely to continue.

State governments around Australia have sought to address this through their own policies – such as the Queensland and Victorian Renewable Energy Targets – but this is not a substitute for national policy. Being a national market, if one state government introduces policies to favour (or harm) particular forms of generation, then this will change investment patterns leading to inefficient investments. The results of this can flow through to other states in the form of artificially high or low prices. In contrast a single, national scheme with bipartisan support and a clear goal creates a suitable environment to allow long-term generation investments to occur. This is the only way to obtain the lowest-cost approach to get affordable, reliable and cleaner electricity.

The Federal Government has now put forward the NEG as a way forward to integrate energy and climate change policy. Until a national climate and energy policy such as the NEG is finalised and implemented with bipartisan support, the policy uncertainty this is likely to continue.

ERM Power considers that the NEG certainly has the potential to give the energy industry the certainty it needs to invest, but it will depend on the detail of the policy. In particular, care must be taken to ensure that the NEG does not further enhance the market power of the existing dominant gentailers.

Although there is limited detail available at present, ERM Power sees a number of risks with the NEG that could lead to enhanced market power at the expense of smaller players in the market. We believe there is a real risk the NEG could damage competition and consumer choice, ultimately leading to higher prices for consumers. Another key element of the policy design will be to ensure that the price of both reliability and emissions is transparent to participants. This will help consumers to understand the impacts of the policy on electricity prices as well as allowing investors in the sector to factor in the expected value of being a low-carbon or dispatchable generator when deciding on what kinds of investments to make. We encourage all sides of New South Wales politics to contribute to the design of the NEG to ensure that the final policy does not harm competition in either the wholesale or retail electricity markets.

Network costs

As has been noted in several reports, one of the major drivers of electricity price increases has been network costs which have increased significantly over the past few years. One of the reasons for this was state government directions to increase the reliability standards for the transmission and distribution networks. This led to networks having to build more infrastructure to meet the increased standard and forecasted increases in demand. These investments have now been made, and based on the current rules, will continue to have an impact on electricity prices for decades to come. Fortunately, the recent removal of the Limited Merits Review may help to dampen future network cost increases over the long term.

Ultimately, this demonstrates one of the challenges of government interference. It was reasonable, and very much in line with broader expectations at the time, to assume that demand would continue to increase. However, a greater attention to energy efficiency, a fall in the costs of solar PV and generous federal and state support for it, alongside changes in the Australian economy, all contributed to falling demand. Electricity assets are long-lived and capital intensive. The decision to invest is better taken by the market, whereby they face the risks, than by the government, where risks are ultimately borne by taxpayers.

As for ERM Power, we actively work with customers to examine their network costs and find ways to lower the network component of their bills. This includes network tariff optimisation – a review of a customer's network tariff to find an option that will save them money – and our 'Demand Alerter' service which automatically sends customers text messages or emails notifying them in advance to take action to keep their maximum demand below the peak demand target. This helps organisations to monitor and control their energy more effectively, and reduce their network demand charges.

Retail markets

ERM Power recommends the Committee look at certain retailer strategies to avoid losing customers. Such tactics can include 'saves', whereby the losing retailer contacts the customer before the end of the 10 day cooling off period to offer a non-widely available offer in order to retain the customer. Another tactic is the 'win-back' strategy where the former retailer contacts the customer shortly after the transfer has taken effect with an improved offer to induce the customer to switch back. The ACCC has criticised win-back strategies in its preliminary report on the grounds that it does not allow for a competitive playing field and threatens competition in the retail market.

From a very narrow perspective, these kinds of tactics appear to be a good outcome for the customer: they receive a better offer from the retailer which enables them to save money. However, these deals typically only last for a short time before prices are increased again. Taking a wider look at the impact of these kinds of strategies on the whole market would also indicate that while the individual customer saves money in the short term, there is a long-term cost imposed on retailers.

This is because for smaller retailers, particularly new entrants, there is a cost attached to acquiring a customer who is then be lured back to one of the dominant, large players after just a few weeks or months. This creates higher costs which are in turn passed on to all consumers.

Larger retailers, particularly those which are vertically integrated, are more capable of absorbing these increased costs due to their economies of scale. Smaller retailers find this more difficult and as such are pushed out of the market, to the overall detriment of competition and consumers.

ERM Power believes that these strategies are in part a response to regulation within the sector. Any change to regulation will lead to retailers responding in a way to comply with new regulations; this will not always be in ways expected by regulators or policy-makers. As such, care must be taken to ensure that any changes implemented as a result of this review do not result in perverse outcomes.

There is also a balance to be struck between transparency in pricing and simplicity for small customers. This is an issue discussed by the Committee in its hearing on 17 November 2017 about whether consumers should have access to the network, generation and retail costs of their final electricity bill.

ERM Power already breaks down bills into these constituent parts for C&I customers in order to increase transparency. Increased transparency in pricing helps to show consumers the impact of different cost drivers on electricity bills allowing them to see the impacts of different policies or decisions. In the case of network charges, which are regulated, there should be no difference between retailers or retailer strategies. Therefore unbundling these charges at the very least would help demonstrate the true difference in prices between different retailers and tariff structures. There may be a case for this to be expanded to other customers including small and medium enterprises (SMEs) and residential.

Additional comments

In ERM Power's experience, discussion on electricity prices tends to focus on residential customers while glossing over the impacts on SMEs and C&I customers. The C&I market in particular differs significantly from the residential market in terms of contracting, sophistication of the parties and the margins available to retailers; margins in the C&I sector are modest. Although some of the issues affecting electricity price rises for residential and C&I customers are similar, ERM Power considers that the Committee needs to recognise the differences between the two sectors as it explores potential solutions to address the underlying cost drivers behind electricity price increases.