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Eastern Australia's Energy Market Outlook 2013

Where: InterContinental Hotel Sydney

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Topic: Key priorities for developing energy markets

Introduction

Thank you for inviting me to speak this morning.

The topic for this session is "key priorities for developing energy markets."

At one level the priorities for development of the stationary energy sector are no different today than they were in the late 1980s, early 1990s when NSW and Victoria started questioning the traditional public utility industry structure and experimenting with the idea of a market, with its shift in risk from customers to equity holders.

Or soon after that when Governments signed up to the Competition Principles Agreement and the Agreement to Implement the National Competition Policy and Related reforms in which "…a fully competitive National Electricity Market (NEM) in southern and eastern Australia…" was one of the major and perhaps most enduring of the so called related reforms.

As an all pervasive input to economic activity, along with labour and efficient capital markets, the productivity and efficiency of the energy sector underpins the productivity, competitiveness and long term growth potential of the economy more generally. Not to mention the welfare of the household sector.

Perhaps many of the issues that have arisen in the last few years owe their origin to the longer term structural links between productivity growth in the domestic energy sector and the country's growth potential not being front of mind.

Governments of course have legitimate policy interests outside of and beyond market and regulatory arrangements that promote productivity growth in the domestic energy sector. Where those interests impact on the sector however, I suspect there is scope to do better at achieving these policy interests while maintaining efficient energy market and regulatory arrangements.

The changes in the gas market, rising electricity prices, debates over climate change, land use and other environmental policies, changes in technology and the relative costs of demand and supply side options and changes in the way energy is used, have all prompted almost unprecedented interest and attention in energy markets. All this increased attention reinforces the need to remain focused on longer-term strategic priorities for energy market development.

The energy prices and other outcomes that we experience as consumers are a combination of:

- the competitive market segments – generation and retail;
- the regulated network sector; and

- the impact of governments' policies – think of the carbon price, the renewable energy target, feed in tariffs and access to gas reserves, for instance.

The way these three combine or interact with one another is just as important as the individual components. When thinking about market development priorities that impact on productivity, prices, reliability, system security, the way energy is used in combination with technology to provide energy services and environmental outcomes you must start with an understanding of how these three inter-relate and affect one another.

One of the strategic priorities the AEMC set out in our last review in 2011 related to the regulation of transmission and distribution networks. A number of changes are already underway in that regard – last year saw the finalisation of the rule changes on the economic regulation of network businesses proposed by the Energy Users Rule Change Committee and the AER. The AER is now in the process of implementing these changes through its better regulation program. The impacts of these new rules on network revenues are expected to start flowing through to customers starting from next year.

While that major piece of work addressed the revenues earned by network businesses, in the next few months we will be looking at the way distribution businesses structure their tariffs. Following recommendations made in the AEMC's

Power of Choice review, we recently received a rule change from SCER to amend the distribution pricing principles in the National Electricity Rules. The goal is to achieve distribution pricing structures that are based on the drivers of network costs, so that as far as possible consumers are facing prices that reflect the impact of their consumption decisions on efficient network costs. One element of the rule change is to require distributors to consult with consumers on their tariff structures. This is consistent with one of the strategic priorities in the 2013 Strategic Priorities Review that the Commission is releasing today.

Strategic priorities review

This is the second strategic priorities review for the AEMC and it sets out three key priorities that we have labelled: a consumer priority, a gas priority and a market priority. The consumer and market priorities are retained from those we developed in 2011, but with a slight re-focus. The gas priority is new.

We aimed to build as much consensus as possible across the sector as to what the key priorities for energy markets should be. This involved considerable consultation with stakeholders including a series of well-attended stakeholder workshops, a public forum and a discussion paper. The positive engagement of stakeholders in preparing this document confirms the value of using a highly consultative and interactive process to develop our strategic priorities. It also reflects the AEMC's responsibility to carry out our work in a transparent, predictable way. This is a theme I will return to.

The consumer priority is about enabling consumers to confidently participate in all parts of the energy supply chain where they desire to do so. This reflects an environment in which consumers are presented with greater opportunities for active participation as technologies advance, retailers differentiate their offerings and competition increases. For example, advanced metering technology is providing richer consumption information and more service possibilities. Distributed generation is blurring the traditional delineation between consumers and producers of electricity. Options for demand-side participation are increasing in retail and generation markets. And the value consumers place on reliability will increasingly feed into the framework for determining network reliability standards and targets.

Our work in this area includes the rule change requests dealing with connecting embedded generators and those that follow from our Power of choice review, such as introducing a demand response mechanism into the wholesale market and a competitive market for the provision of metering services. We will also shortly be releasing our consumer engagement blueprint which is a supplementary report to the NSW Retail Competition Review and has broad applicability to energy markets. It includes recommendations on how to provide the information, tools and support that consumers have told us they want in order to choose energy plans that are right for them.

The gas priority is about the development of efficient gas markets. Our work to address this priority has recently begun with the publication of the gas market scoping study.

The market priority, which is somewhat an overarching priority, is about an effective market, regulatory and policy environment for investment. Because future investment requirements are relatively uncertain, market arrangements must be flexible enough to facilitate investments that can be adapted in line with changing policies, market conditions and external factors.

Our current work relevant to this market priority includes our transmission and distribution reliability frameworks review, as well as the Reliability Panel's review of the reliability settings which determine the price envelope for the wholesale market, our NEM financial market resilience project, and the detailed design and testing of the optional firm access proposal.

As I said earlier, the consumer and market priorities are evolutions of two of the priorities we developed in 2011, reflecting their continued importance at the centre of effective energy market arrangements. However, today I would like to focus a little more on the new priority – the development of efficient gas markets.

Gas in eastern Australia

Over the last 10 to 15 years the domestic gas market has been relatively stable. Growth has mainly occurred in the gas-fired generation sector. Gas prices were locked in through contracts, generally subject to an annual adjustment for inflation.

The east coast market is now experiencing a structural increase to both demand and supply in response to the establishment of an LNG export industry. Although export will not commence until late-2014, the domestic market is already feeling the effects of greater competition for gas.

On the supply-side, the key uncertainty appears to be whether sufficient reserves can be developed in time to meet LNG export schedules and the needs of domestic users, with domestic contracts rolling off at around the same time the LNG projects are ramping up.

From a demand perspective, a new market dynamic facing domestic gas users is the competing LNG export industry – and the effect that has on prices. The way prices are determined also looks to be changing, with links to the oil price reflecting the influence of LNG pricing.

As the east coast gas market transitions to this new paradigm influenced by international energy markets, there has been a renewed focus on the efficiency of the gas supply chain.

What does this mean for market participants and consumers?

Long term contracts are a feature of the gas market due to the capital intensive nature and long lives of the assets, and the needs of large end users who also require certainty of supply and price to secure finance for their own activities.

A positive feature of these arrangements is that the risk associated with investment in gas infrastructure is appropriately borne by the investor. These contracting arrangements in gas provide certainty to producers, pipeline owners and end-users.

On the other hand, the widespread use of contracts, which are usually confidential, limits gas pricing transparency. However, as the eastern market has matured and the number of participants increased, producers and pipeline owners have recovered a significant proportion of their initial investment and have been willing to enter into shorter term contracts. A limited amount of trading also takes place on spot markets where prices can be seen; however, this is primarily for the purpose of participants managing daily gas imbalances, rather than acting as the source of supply.

An increase in the use of markets to undertake short term trades of gas and pipeline capacity is an attribute of mature and well developed gas markets around the world. However, given the size of the Australian gas industry, it is not yet clear how many trading markets can be efficiently supported, while providing the liquidity and depth that supports credible price signals and financial hedging products.

Gas as a strategic priority

Consistent with the AEMC's remit, this gas strategic priority is focused on the means of exchange used in downstream parts of the supply chain from when the gas enters the pipeline system to its delivery to end users.

This kind of work will not directly address the well-publicised upstream supply-side issues currently affecting the eastern gas market. Nonetheless, we recognise the importance of the way gas is bought and sold as part of the overall efficiency of the natural gas supply chain.

Throughout the strategic priorities review process, we received considerable support from stakeholders to focus on this aspect of gas markets as one of our three strategic priorities.

Gas scoping study

The AEMC also commissioned a scoping study on the current state of the east coast gas market that we published at the end of September. It provides an overview of changes underway and identifies areas of potential improvement in the downstream market and regulatory arrangements.

Over 20 interviews were conducted with market participants, a public workshop was held in Sydney, and eight submissions were received as part of the consultation process in undertaking this work.

Over the last 10 years there has been substantial investment in transmission pipelines, with the eastern gas market now fully integrated. Increased trading flexibility and information transparency has also occurred through initiatives such as the Short Term Trading Markets, Bulletin Board and Gas Statement of Opportunities.

However, the scale of the changes which are occurring in the gas sector means that it is important to evaluate whether the existing downstream market frameworks continue to be well suited to the new environment in which they are now placed, taking into account the commercial and practical needs of participants. In effect, it was considered prudent to take stock.

Given the uncertainty that exists around what direction that downstream gas market development should take over the next 10 to 15 years, the scoping study identified the need for a strategic gas market development path within which the industry can work towards achieving a more mature and well-functioning market.

Good energy policy must be marinated

That sentiment strikes at what former Federal Energy Minister Martin Ferguson recently wrote in a piece in the AFR – that “good energy policy must be marinated”. That is, whilst the time it takes to develop policy may frustrate some, stakeholders and policy makers need time to conduct the processes that underpin good policy. Time to consult, time to listen and time to learn from each other.

Not only is good process more likely to produce the best long term outcomes, it also helps to bring along stakeholders with the process. A good policy may risk failure if it does not have buy-in from those affected.

The AEMC's processes for its rule change requests and reviews are reflected in the process we undertook in developing our strategic priorities. We consulted with a broad audience to build consensus around the future focus for developing energy markets.

In December, the NEM will mark its fifteen year anniversary since its commencement. While the development of the NEM can be seen as a landmark microeconomic reform, it also represents a successful process of developing and implementing enduring reform. One that continues.

In the discussion of our market priority in today's report we make the point that it is important that all policy and regulatory decisions understand the impacts on sectors they are likely to affect.

The Business Council of Australia's recent "Action Plan for Enduring Prosperity" suggested that "Australia needs an integrated approach to energy and climate change mitigation policy that is coherent with our economic goals."

Some stakeholders argue that the way to achieve better integration would be to change the National Electricity Objective. My response would be that the current NEM governance arrangements benefit from two key attributes: a clear and appropriate allocation of roles and clear objectives associated with each role. This brings clarity, transparency and accountability to the decision-making of the respective institutions.

When I was asked about this issue at the Senate Inquiry on Electricity Prices last year, I compared good governance arrangements to a good football team.

Everyone on the team has the same objective – in this case market and regulatory arrangements that deliver outcomes in the long term interests of consumers – but we all have our own position and our own role. If the prop thinks that the five-eighth is not doing a good job, the worst thing he can do is try to do the five-eight's job for him. The AEMC's role in making and amending the rules that apply to the energy sector is one position in the team, albeit an important one.

There are other manifestations of government that play in different positions: they deal with environmental issues in a systemic sense, such as climate change and in a local sense, such as land use planning. The same around social policy. And the expertise in these areas is necessarily different. Just like a football team, we all have different roles, but we get the best outcomes when the people in those different roles coordinate with one another.

Coordination and information sharing is precisely why process is so important in developing good energy policy. Not only between governments but between regulated and unregulated parts of the markets, and those most impacted by changes: consumers.

Thank you.