Australian Energy Market Commission

SPEECH BY COMMISSIONER NEVILLE HENDERSON AT 2014 EUAA CONFERENCE

Power of Choice and other energy market reforms

13 October 2014

Check against delivery

I'd like to start by acknowledging the traditional owners of the land on which we meet and pay my respects to their elders both past and present.

Can I also thank Phil Barresi, CEO of the Energy Users Association of Australia for inviting the AEMC to address you today and pass on my apologies that Chairman John Pierce cannot be here.

When John spoke at this conference last year – which I'm sure many of you attended, he talked about some of the key drivers of electricity price rises in recent years – environmental policies and investments in the distribution network, principal among them.

He also talked about the strategic priorities of the Australian Energy Market Commission and some of the work under way as part of the Power of Choice reforms, which hold promise for both small and large energy users.

Twelve months later, there has been significant change for our sector in terms of policy and regulation which affect energy prices.

It can be helpful to think about those things which affect energy prices as grouped into three broad areas.

- The competitive sectors in retail and generation;
- The regulated distribution and transmission network; and
- Other policies which sit in non-energy portfolio areas – mainly environmental policies – that impact on the energy sector.

In terms of the latter, the carbon tax has been removed and we are knee-deep in a public discussion about the future of the Renewable Energy Target.

In terms of the distribution network, the AEMC's new rules governing how the Australian Energy Regulator will approve network revenue are starting to be implemented and we are seeing networks engaging with consumers, large and small, directly on their investment plans.

We have also just seen the Federal Government's Energy Green Paper, which will no doubt see in some changes for the energy sector.

So reforms to the electricity market therefore continue to move forward and this has been helped by the governance model that has developed since the inception of the National Electricity Market.

As most of you know, the AEMC is the rule maker for most parts of the supply chain across electricity and natural gas.

We also provide advice to governments on energy market development, based on Terms of Reference provided to us by the COAG Energy Council.

We do not initiate our own rule change requests and instead rely on requests from governments, market participants and indeed any other party who sees an issue to be addressed.

So the remit of the AEMC and other market institutions, including the AER and AEMO, covers the first two of these three elements impacting prices – the competitive sectors and network regulation.

There are some clear advantages to this governance model, particularly in the clarity of roles and responsibilities across the different institutions.

It does however mean that the delivery of rule changes can be tied to the timeframes and deliberations of other market institutions.

The Power of Choice reforms are a good example of what this means in practice.

The final Power of Choice report and proposed implementation plan were provided to the COAG Energy Council for their consideration in November 2012.

This included a range of recommendations to improve demand side participation in energy markets. The five rule change requests that came out of the Power of Choice Review took about a year to be agreed upon and submitted to the AEMC.

And once we receive the rule change requests we undertake a thorough process of consultation and engagement to make sure that all stakeholders have a chance to contribute to the debate.

This generally involves Consultation Paper, public forums, targeted stakeholder workshops with further consultation on a Draft Determination, before a Final Determination is made.

These sorts of timelines can sometimes frustrate those keen to see reforms progressed quickly.

The Commission shares the eagerness of many, including the EUAA to see the potential of the Power of Choice review realised.

The principle behind the review – to give energy users, including commercial and industrial consumers, choice, and allowing those choices to drive energy market development – continues to motivate the AEMC's priorities and work program.

Today I'd like to focus on a few of the key reforms coming out of the Power of Choice review – changes to how distribution network tariffs are determined and expanding competition in metering and related services.

As I mentioned earlier, the overall amount of revenue networks are able to recover has been dealt with in earlier rule changes, particularly, the rule change in relation to Economic Regulation of Network Service Providers in 2012.

As you will remember, these changes related to the rules governing how the maximum revenue a network business recovers from all consumers is determined by the AER.

The changes included a new rate of return framework that is common to electricity distribution, electricity transmission and gas.

It requires the AER to make the best possible estimate of the rate of return at the time a regulatory determination is made, taking into account market circumstances, estimation methods, financial models and other relevant information.

The AER is required to undertake an open and consultative process at least every three years to develop its approach to setting the rate of return.

The new common framework also enables the regulator to take a range of different approaches to estimate the return on debt component, potentially allowing for reduced risk for debt financing for network businesses.

And importantly, it removes ambiguities regarding the powers of the AER to interrogate, review and amend capital and operating expenditure proposals submitted by network service providers.

The AER's authority in this area has withstood Tribunal review, so you as consumers can feel confident that a robust regulatory mechanism is in place so that total revenues collected are appropriately determined.

Building on this, the rule change we're working on currently – changes to distribution network pricing arrangements – looks at how that revenue is recovered. Making sure that the structure of network tariffs is helping to send efficient price signals back to consumers and in the process removing cross-subsidisation between consumers.

Big energy users like many of your businesses tend to have a sophisticated understanding of their energy use largely due to the size and significance of that cost to running their business.

You're probably also aware of the significant proportion of your bill that is made up of network charges.

Manufacturing, commercial and industrial, and electricity, gas water and waste services, are responsible for around 63 per cent of Australia's electricity use.

Most if not all of you have interval meters so you are aware of how and when you use power. What has been missing is the ability to use the information you receive from your meter to influence that large bucket of network charges.

The price signals you currently receive are largely 'muffled' by a distribution network pricing structure which is not cost reflective.

Under current price structures, energy users pay the same network price even if the costs of such usage vary by location and time, regardless of how or when they are using power.

Existing network prices over-recover revenue for off-peak use of the network and under-recover for peak use.

This means energy users who use most of their energy at off-peak times are paying more than it costs to supply network services to them – while those using energy at peak times are paying less than it costs.

As an example, a residential consumer using a large 5kW air-conditioner in peak times will cause about $1,000 a year in additional network costs compared with a similar energy user without an air-conditioner.

But this residential consumer with the air-conditioner pays about an extra $300 under the most common network prices.

The remaining $700 is recovered from other consumers, big and small, through higher network charges.

Our Draft Determination on distribution network pricing will create the conditions for network prices paid by individual consumers and businesses to better reflect the cost of providing network services to them. It will allow more efficient price signals to emerge, removing cross subsidisation and giving energy users the information they need to decide what technologies might work best for them to manage usage, and help reduce their energy costs.

We have analysed the impact of the changes to distribution network pricing arrangements on residential customers. That analysis estimates that up to 81 per cent of residential consumers would face lower network charges in the medium term under a cost-reflective capacity price and up to 69 per cent would see lower charges under a critical peak price.

The next piece of work, which we have recently commissioned, looks at the likely impact on business – particularly larger commercial and industrial energy users.

We do, of course, have some relevant experience to draw on – Ausnet already offers flexible pricing for network services in their distribution area in Victoria.

If you're a business with a relatively flat load profile you should see lower network charges, reflecting the lower demands you place on the grid.

And some energy users will choose to respond to new network price structures by further reducing their use of the network at peak times, which will reduce overall network costs, with savings passed on to them.

The AEMC's draft rule also sets out new processes and timeframes for setting network prices to improve certainty, timeliness and transparency for consumers and retailers. This should help businesses plan their expenditure more effectively and avoid bill shocks.

The Commission fully appreciates the eagerness of this sector – the EUAA and its members – to see this rule change progressed.

There have been claims by some that no concrete action is planned for the short term. That is wrong.

A final determination on this rule change is due to be published in November. This will include a phased implementation plan to give industry and consumers time to adjust to the change, with the new rules to be implemented progressively between next year and 2017 in all jurisdictions, depending on when regulatory determination cycles occur.

Linked with the distribution network changes, is another Power of Choice building block, aimed at creating opportunities for a competitive energy services market.

We don't necessarily know which technologies will develop in the future or how they will be used, but we know technology will empower all consumers and help drive innovation and change.

And it will do that best if there is competition in the market for these products and services.

The rule change to promote competition in metering and related services, along with the open access and common communications standards framework for smart meters, as well as arrangements to allow multiple trading relationships at the consumer's connection point - these reforms will all work together to provide energy users a greater armoury of tools to respond to market signals and make decisions about the best and most efficient way for your business to consume energy.

A discussion paper on the competition in metering and related services rule change is currently online and we've just completed a series of stakeholder workshops as part of that consultation process.

I'd like to turn now to the third area I identified earlier as influencing energy market outcomes – the integration of policies outside the energy portfolio.

Governments legitimately have a range of policy objectives in addition to energy policy objectives.

The Renewable Energy Target does not need to be designed in a way that negatively interferes with the goal of efficient markets.

The desire to encourage renewable generation need not be at the expense of the wholesale market.

The RET in its current form is not able to adjust to prevailing market conditions.

As demand has fallen, new renewable capacity has continued to be developed. Falling demand in an efficient energy-only wholesale market like the NEM would signal to generators that no new capacity is required. The RET however provides an incentive for additional build.

In this sense the RET has shifted the risk allocation in the National Electricity Market.

Prior to the RET, generators bore the risk of their assets being under-utilised by falling demand.

Generation built under the auspices of the RET does not bear that risk which instead has been transferred to consumers in the form of retailer compliance costs.

The effect of this has been to create a disconnect between retail and wholesale prices. So there is a wedge between retail and wholesale prices, where the former has increased given the obligation on retailers to procure renewable certificates, while the latter prevents the appropriate demand-side response and ultimately the efficient clearing of the wholesale market.

In our submission to the RET review, we proposed two possible solutions.

First, moving the RET to a floating target, as opposed to a fixed GWh target. This would shift the allocation of demand risk away from consumers and more appropriately share it amongst investors – renewable and thermal – who are better placed to manage such risk and profit from efficient decisions.

The Commission believes this is a more sustainable approach, allowing the RET to better integrate with the structure of the National Electricity Market.

An alternative we put forward is to Transition the RET to an emissions intensity based scheme for the electricity sector.

This scheme could be designed in a number of ways, including where generators below a defined emissions intensity level create certificates that generators above the level are liable to purchase.

Retailers and other liable entities under the current RET scheme would not participate directly.

This type of approach would encourage all lower emissions technology options, not only renewable energy, and is therefore likely to meet any emissions reduction target at a lower cost – and that means lower energy bills for small and large consumers.

Both options would provide a viable path forward and greater certainty for large energy users.

Finally, I want to update you on the AEMC's work in relation to gas markets.

Promoting the development of efficient gas markets is one of the AEMC's strategic priorities.

There are major structural shifts occurring in gas as we ramp up to LNG exports from Gladstone.

Given these developments, last year the AEMC initiated a scoping study to consult with stakeholders and identify areas of potential improvement in the market and regulatory arrangements.

One of our key findings was the need for an integrated gas market development plan within which the industry can work towards achieving a mature and well-functioning market.

This would help build certainty around what the LNG export developments mean for the domestic market and the direction that gas market development should take in response.

An important part of this work will be to consider the future role and objectives of the gas trading hubs on the east coast, including possible reforms to trading hubs which might increase the ability for market participants to manage risk and in turn facilitate greater trading and liquidity.

Over time, we expect that this type of gas market development work will lower barriers to entry in these markets and promote greater competition by providing gas users with additional options for sourcing their gas.

We are engaging with governments and stakeholders to support a gas market framework which continues to promote efficiency and competition.

The last twelve months really has seen substantial change in the energy sector and there is much to be optimistic about.

Some changes to environmental policies are having an immediate dampening effect on energy prices. While others are still being determined but we are hopeful of a decision that supports efficient market outcomes.

I believe we are making headway in getting a more reasonable approach to approvals of distribution network revenues, and the removal of cross-subsidies in network tariffs.

Change can be good if it's relatively predictable and its objectives widely understood.

Ultimately that is what I think the AEMC, through its work with governments and stakeholders, is trying to achieve – a pathway forward and a sensible and sustainable set of policies and rules which are predictable, coherent and work together, or integrate, to encourage competition in the energy sector.

I look forward to continuing to work with the EUAA and its members to promote the development of robust, competitive markets that will continue to support the vital contributions that your businesses make to the Australian economy.

Thank you.

ENDS

Neville Henderson
Commissioner
Australian Energy Market Commission

Check against delivery