



Australian Energy Market Commission

SPEECH BY COMMISSIONER JOHN PIERCE AT 2014 NEM FUTURE FORUM

*A consumer driven market: the next chapter in a
national productivity improvement story*

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Thank you for being here today to discuss the future of the National Electricity Market.

Before we begin, I'd like to acknowledge the traditional owners of the land on which we meet and pay my respects to their elders both past and present. I'd also like to acknowledge:

- Keith Orchison, our Chair today, and
- All our other speakers.

I've been asked to speak about where the national energy market is now, and where it's headed in the future.

As a Commission, we are in a sense quite agnostic about the future. We are not in the business of making forecasts of demand, prices, relative costs and technologies.

In performing our role, we don't need to, because ultimately it will be consumers doing what consumers do – making consumption decisions based on the price and service options available to them – that will drive the way the sector develops.

But where we are now?

The National Electricity Market has been on a fairly consistent reform path over the past 25 years or so.

I don't intend to give a history lesson today, but briefly: the reform of the energy sector was part of a major period of economic reform kicked off in the 80s, which included reforming a set of capital intensive utility services such as energy, communications, transport and water, whose performance was not supporting long term economic growth to the extent that it could.

These assets were state owned, centrally organised and monopolistic.

Since then, the story in our sector has been one of separating policy and regulatory functions from industry; industry restructuring; and bringing competition to the sector.

A key characteristic of the old industry structure – and one that makes what we have today in the competitive generation and retail sectors different – is where demand and investment risks fall and the way they are managed.

It is in fact how these risks are allocated between consumers and businesses that determines whether 'what we have' deserves to be called a market at all.

Numerous reports and reviews dating back to the 1986 McDonnell and 1988 Curran inquiries in NSW, through to the Western Australian Economic Regulatory Authorities' report on that State's wholesale electricity market published last year, show that wherever you have a central authority determining how the sector is to develop – how much investment is to occur – how much capacity is to be built or procured based on fallible forecasts of the future – the costs of getting these decisions wrong rests with consumers.

For the future of the sector to be driven by consumers deciding what is of value to them, one of the prerequisites is that demand and investment risks are managed by businesses, operating in a workably competitive market.

You don't need to believe – though you may choose to – that people making investment decisions based on forecasts of the future working within an AGL or Origin or Alinta, are any better at foretelling the future than people – possibly the same people – working within a central authority. The point is the risk allocation, the way it's managed and the associated incentives are different.

We have come a long way but there is, of course, work to be done.

We have clearly commenced a new stage where the NEM's development is driven by consumers making choices about the way they source and use energy.

The measures set out in the Commission's Power of Choice reform package, and the reviews of retail competition, which included proposals to address the way distribution tariffs are structured that are now at the Draft Rule stage, are about facilitating consumers move from the "back seat" to the "driver's seat" – giving them better information and tools to make informed choices about their energy consumption.

A key question though is will they find it a comfortable seat and a pleasant experience?

Consumers – that is, people – need to be as comfortable making choices about energy as they are picking items off the supermarket shelf.

When you think about the process of choosing products at a supermarket, a consumer is able to scan a shelf, run their eye past the Tim Tams, the Iced Vovos, the Mint Slices (a personal favourite), the Scotch Fingers, and all the while weighing up taste, quality, price, your attempt to be virtuous with respect to diet. And pretty quickly narrowing it down to a couple of options – the Iced Vovos and the Mint Slices – and buy both.

Granted energy is a little more complicated than that, but fundamentally we want to get to a place where consumers are as comfortable making decisions about energy as they are other products and services, where competition and choice is taken for granted.

And to do that people need information; they need tools; they need to be engaged; they need a *reason* to be engaged; and they need the price they pay for energy to reflect the cost of supplying them, as individuals.

Together, the AEMC's Power of Choice reforms and the lessons from our reviews of retail competition are key to achieving these objectives.

One of the Power of Choice building blocks is the distribution network pricing rule change, which aims to have network prices paid by individual consumers better reflect the cost of providing network services to them.

Currently, even if the total costs of network services is at efficient levels, many individual consumers pay more than the costs caused by their usage, because of the way network prices are structured. Other consumers, in particular those that use a greater proportion of their energy at peak times, pay less than the costs caused by their usage.

Existing network price structures over-recover for off-peak use of the network and under-recover for peak use. In the draft rule determination, we include a number of case studies to explain this.

By way of example a consumer using an average size north facing solar PV system will save themselves about \$200 a year in network charges compared with a similar consumer without solar.

Because most of the solar energy is generated at non-peak times, it reduces the network's costs by \$80, leaving other consumers to make up the \$120 shortfall through higher charges.

The same consumer could reduce network costs considerably and align with the savings they receive, by facing their panels west, generating more energy

at peak times when it is most needed. That is, less energy in total, but more when it is most valued.

Under the existing network pricing arrangements, the consumer has no incentive to do so as they benefit more by generating more total energy throughout the day.

Equally, a 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 consumer without an air-conditioner.

But the consumer with the air-conditioner pays about an extra \$300 under the most common network prices. The remaining \$700 is recovered from all other consumers through higher network charges.

In both examples, some consumers are paying more than it costs to provide services to them, and others less.

The objective of the changes set out in our recent Draft Determination is that network prices paid by individual consumers better reflect the cost of providing network services to them, as individuals.

This will allow consumers to make more informed choices about what energy services they value.

It will also give consumers the information they need to decide what technologies might work best for them to manage their usage, and help reduce their energy charges.

From a market and overall system point of view, it will mean consumers' choices are the driving force behind market development and investment and provide the conditions for a more effective and competitive energy market.

Of course it's one thing to create the market conditions for choice, but consumers also need the tools to respond to market price signals.

Another important Power of Choice building block is creating opportunities for a competitive energy services market.

It goes without saying that consumers use of technology will be a huge part of the process in driving change and market development in coming years.

We don't necessarily know which technologies or how they will be used, which is precisely why the Commission's policy work is agnostic about technological development, but we know they will drive innovation and change and the system must be flexible enough to respond to that change.

The rule change to promote competition in metering and related services; the open access and common communications standards framework for smart meters; arrangements to allow multiple trading relationships at the consumer's

connection point; and measures to improve the switching process – these reforms will all work together to help the energy services market evolve in a way that supports consumer choice.

So how might we predict the future for the National Energy Market?

My advice is to follow the consumer.

They're in the driving seat and technology is propelling them very quickly in relatively unpredictable ways.

Increasingly, they're expecting engagement. Not only to be consulted on industry and regulatory activity but to actively participate in the energy market.

So in terms of how the Australian Energy Market Commission sees the energy market of the future, we don't plan to bet on any single possible future.

Instead, we want a system which is flexible enough to respond to the increasingly sophisticated and diverse demands of consumers, which allows their choices and preferences to drive market development.

But, we won't get there if we start fiddling with the way energy is bought and sold (the means of exchange) or if there are policy interventions in the market that undermine its operation and the ability of price to reflect underlying demand and supply conditions.

So let's talk about capacity (so called) "markets".

There has been increased chatter in recent times suggesting that there may be a case for a fundamental redesign of the wholesale energy market – a move to a capacity (so called) "market".

This, at least in part, appears to be motivated by the current disconnect between wholesale and retail prices and generation oversupply.

The WA energy market is a good local example of the problem with capacity markets and the WA Government is currently grappling with what to do about the problems they cause – predominantly higher risk and generally higher prices for consumers.

The WEM is typical of other capacity markets in that it relies on a central authority to predict and procure generation capacity.

If your system requires an omnipresent, all knowing being – let's call him or her 'god' – to understand a system completely, have perfect powers of prediction and to know what capacity should be set to match future demand, the only thing you can perfectly predict is that god will be wrong.

In reality, typically in capacity markets our omnipresent, perfect bureaucrat will contract or regulate for too much supply, because that is the rational thing to do given the incentives god faces.

And when he or she gets it wrong and over contracts, the consumer pays.

That is certainly the case in WA. It was the case in the “olden days” of the state-based utilities. The consequence of this type of structure is that demand risks fall on consumers.

We’ve well and truly moved away from this era in the NEM – indeed as I’ve spent most of today’s speech talking about, we are headed in exactly the opposite direction.

So the message to those intending to fiddle with the development of a consumer driven energy market and revert to the risk allocation of the old days is a simple one – you are heading in the wrong direction.

Part of the underlying issue here of course, is the impact of bringing together the way the energy market works with the particular way the Renewable Energy Target is designed.

In effect, because the RET sets a specific GWh target, its risk allocation is the same as a capacity (so called) “market”.

These issues of the interface between the two have always been there, but have only become more evident with the drop off in demand growth.

Governments legitimately have a range of policy objectives in addition to the traditional energy policy objectives. That’s why we have elected governments to specify policy objectives.

But in achieving these different objectives we must be careful, wherever possible, not to jeopardise the achievement of one to the benefit of another.

When contemplating the effective integration of energy and environmental policy, it is important to design a mechanism to achieve an emissions reduction objective that preserves the means of exchange and allocation of risk in energy markets. Because these are the characteristics that make the energy market, a “market” in the first place.

For the NEM to be an effective market, it must be able to respond to changes in demand driven by consumer preferences, changes in technology and other factors, like relative prices, which cannot necessarily be predicted.

For a policy to be sustainable there needs to be a reasonable opportunity to adapt to material changes in market conditions, in a consistent manner.

Robust policy positions should not be predicated on one particular view of the future.

For environmental policy like the RET to be sustainable, investors also need a level of confidence that policy objectives can be met and are sufficiently robust to adjust to changes in market conditions.

It is due to the divergence in the risk allocation mechanisms in the energy market on the one hand, and the current RET design on the other, that we proposed, in our submission to the RET review, moving the RET to a floating 20 per cent target in 2020, as opposed to a fixed GWh target.

The important point is not even the level at which the target is set – let's call the target "X" – it's that it is "X per cent" of whatever demand happens to be.

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.

While consumers are going to drive much of the change we experience in the energy market in the coming years through their demands and preferences, we also have to make sure the benefits flow to all consumers.

And we must ensure some consumers don't get lost in the change and the increasing diversification of the sector. This involves a massive communications challenge.

In May this year, the Commission held its first strategic priorities forum with consumer representatives in order to deepen our relationships with consumers and their advocates as we consider the agenda ahead of us.

Consumer engagement was right at the top of the list of issues we are dealing with, particularly ensuring they having full information about contracts, offers and changes related to new flexible pricing structures.

Equally significant to consumer groups was the impact of energy prices, along with the importance of consumer protections, particularly those that support more vulnerable and low income consumers.

So we need to be able to respond to those concerns about ensuring all consumers benefit from greater competition, and respond to concerns about the necessary consumer protections needed into the future.

Many consumers need the information and confidence to become more engaged in shopping for energy. Our Consumer Engagement Blueprint for the review of competition in NSW energy retail markets recommended strategies to achieve this, including:

- providing information to consumers that uses different channels to target specific consumer segments as well as the broader community,
- refinements to existing comparison tools so that consumers have a trusted source of advice that allows 'apples for apples' comparisons, many of which are already being considered by the AER, and
- providing additional support to consumers that need it.

And many of these reforms are being rolled out with some good results.

For example, it was encouraging to see in our recent report on competition in retail electricity and gas markets that 90 per cent of all consumers were aware they could choose their energy company, up to 40 per cent had actively investigated options, and up to 28 per cent had actually switched during 2013.

Consumers are shopping around for better gas and electricity deals more often than they are switching insurance companies, or phone and internet providers.

New retailers are entering markets and winning customers with discounts and other incentives, with conservative estimates of savings from \$60 to \$240 or more a year, depending on where they live and how much electricity they use.

The other aspect of the communications challenge is to understand that there are an increasing number of already engaged consumers – energy literate consumers – who want an entirely different energy product compared with what has been provided to them in the past.

So as we embrace the challenge of responding to diverse needs – from highly energy literate consumers, to more traditional consumers, to vulnerable consumers – it will be important to have a market that is flexible and able to respond to diversity and range of possible future scenarios.

In the years to come, the structure of the energy sector may be quite different to the one we see today.

The increased interest of new technology providers in our sector has the potential to reshape the way we think of an energy services provider.

The increased use of electric cars, the uptake of home energy management systems and technologies, and other possible demand game changers, which may work in completely opposite directions

All this has the potential to change the face of the energy sector.

The focus of the AEMC – the agnostic AEMC – is to care deeply about the future and develop the NEM into a market that is flexible and able to respond to whatever the future holds.

Thank you for listening and enjoy what promises to be a fascinating day's discussion.

ENDS

John Pierce

Chairman

Australian Energy Market Commission

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