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Mr John Pierce
Chairman
Australia Energy Market Commission
PO Box A2449
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Dear Mr Pierce,

STRATEGIC PRIORITIES FOR ENERGY MARKET DEVELOPMENT

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy policy in Victoria makes the following submission in relation to the Australian Energy Market Commission's (AEMC) *"Strategic Priorities for Energy Market Development, Discussion paper"*.

Any queries in relation to the submission should be directed to Mr Mark Feather, Director National Energy Development by email at mark.feather@dpi.vic.gov.au or on telephone (03) 9658 4793.

DPI welcomes the AEMC's first Strategic Priorities document and agrees that the AEMC has an important role in providing advice to government on the challenges facing the energy sector and the opportunities that exist for the continued development of competitive energy markets in Australia.

Ultimately, the AEMC's identification of Strategic Priorities for the energy sector should help to inform the strategic direction of the Standing Council on Energy and Resources (SCER) which is due to be formed in July 2011 and which will merge and take over the functions of the Ministerial Council on Energy and Ministerial Council on Mineral and Petroleum Resources.

DPI broadly agrees with the strategic priorities for the energy sector which are set out in the AEMC's document. However, DPI considers that there are two other critical priorities for the energy sector at present which are not fully reflected in the document. Whilst these priorities may not currently fall within the remit of the AEMC and are potentially matters for SCER consideration we consider that they should be highlighted. The additional priorities are as follows:

Carbon price and climate change adaptation

With the potential introduction of carbon pricing policies, the electricity sector will face an unprecedented investment challenge and technological transformation on a scale that has not previously occurred within the National Electricity Market (NEM) framework. In particular, the potential large scale exit of existing generation from the market and the requirements for significant levels of new investment in low carbon generation technologies could produce material risks to the market from a security of supply perspective. DPI considers that it will be necessary to, at the very least, identify and manage the risks associated with the transition and to consider what changes to the market frameworks are required to deliver an orderly transition that preserves security of supply.

For example, it will be important for regulators and governments to fully understand the risks to the market, and ultimately consumers, of sudden financial shocks on large generators associated with the introduction of carbon prices and where necessary to put in place arrangements to monitor and manage these impacts.

In this respect, DPI agrees with the observations contained in the Strategic Priorities report that it is prudent to consider what mechanisms are in place to limit the extent of disruption and systemic risk to markets as a whole if individual market participants become commercially distressed. This includes consideration of potential contagion impacts associated with base-load generators experiencing financial shocks. As the AEMC has noted, in a period of potentially rapid change there may be enhanced risks of unexpected commercial events.

In addition to addressing the short term impacts and risks associated with sudden financial shocks, it will also be necessary to consider the extent to which the commercial and regulatory framework within the NEM provides a stable investment environment and therefore an orderly transition through the entry of new large scale generation plant (e.g. gas fired base-load generation).

In this respect it will be important to understand the timing associated with the exit of large scale brown coal based generation and the interaction of this with new generation investment. Similarly it will be important to understand whether some generation facilities will continue to operate intermittently (for example, in summer months) as new base-load generation enters the market.

In practical terms, the operational and exit decisions of large scale base-load coal fired generators may have implications for new investors in new base-load generation and consideration may need to be given to whether there needs to be increased market transparency governing the timing of these exit decisions in order to facilitate an orderly transition within the competitive market framework.

Ultimately, DPI considers that the market and pricing mechanisms that are provided within the National Energy Market (NEM) should be able to deliver efficient investment as the market enters its first major investment cycle. Nevertheless, it will be prudent to ensure that the risks to security of supply associated with such a major transformation are identified and managed.

Economic regulation of networks

In its Strategic Priorities paper, the AEMC has noted the challenges facing the market in terms of rising network charges. The AEMC has noted that increased network prices are being driven by a number of factors including replacement of ageing assets, demand growth, State based reliability standards and decisions by the Australian Energy Regulator (AER) and Australian Competition Tribunal on the cost of capital allowed to network businesses.

The AEMC has also noted that the AER is currently undertaking a review of the rules associated with the economic regulation of network businesses ahead of the next cycle of distribution pricing reviews. This review may ultimately lead to rule changes which will subsequently be assessed by the AEMC.

DPI considers that the framework governing economic regulation of the network businesses is currently facing significant challenges with network businesses seeking substantial increases in capital and operational expenditure allowances. These challenges are likely to continue in the future as network investment is needed to replace ageing infrastructure and meet demand growth. The network sector, particularly transmission networks, will also face investment pressures as a result of changing patterns of generation driven by climate change policies.

In Victoria, the AER's October 2010 Final Pricing Determination provided for a 45 per cent increase on capital expenditure of the electricity distribution businesses above 2006-10 levels and a 32 per cent increase in operational expenditure above 2006-10 levels. The AER's decision will ultimately provide for a 2.6 per cent per year price increase on average across the Victorian electricity distribution networks. Further, consumers in other jurisdictions such as New South Wales, South Australia and Queensland will face more significant network pricing increases.

The recent trend of increasing network prices has also been the subject of commentary in the recent Garnaut paper (8th Update Paper, "Transforming the Electricity Sector") and in IPART's report on "Changes in regulated electricity retail prices from 1 July 2011". Both these reports raise substantial concerns with the framework and rules governing network regulation. These include, amongst other things:

- the level of prescription within the National Energy Regulator governing the AER's decisions;
- the requirement that all capital expenditure be rolled into network asset bases;
- incentives on network businesses to overstate their capital and operational expenditure requirements during pricing review determinations;
- an asymmetric merits review framework that enables network businesses to appeal aspects of the regulator's determination with limited down-side risk;
- requirements for the setting of cost of debt allowances that are not aligned with the risks of the network businesses; and
- conservative and deterministic reliability standards which lead to excessive investment and overbuilding.

It is noted that DPI shares many of these concerns. Indeed the Victorian Government has raised concerns regarding aspects of the rules governing distribution regulation in its intervention in the present merits review of the AER's Victorian electricity distribution determination for 2011-15.

More broadly, DPI believes that there is a case for a broader SCER led review which would enable consideration of a number of these issues, some of which go beyond the scope of rule changes that could be considered by the AEMC (for example, the merits review process).

Ultimately, given the cost of living impacts associated with rising network charges, it is critical that the regulatory, governance and commercial frameworks promote effective and robust regulation of networks and deliver effective incentives on networks to ensure efficient network investment and operation. The concerns that have been raised by expert commentators in this area raise significant issues which DPI considers warrant further assessment and analysis.

Comments on the AEMC's priorities

In addition to the issues highlighted above, DPI provides the following comments on the priorities identified in the document.

Strategic Priority One – Predictable regulatory and market environment

DPI agrees that predictable regulatory and market environments are important for facilitating investment in long lived assets such as generation and network infrastructure. DPI would note that uncertainty over future carbon policies is at present having negative impacts on investment in the generation sector. Ultimately, long term certainty governing any future market and commercial framework for the pricing of carbon will be critical to ensuring efficient investment in base-load generation going forward. In this respect, DPI agrees with the AEMC that carbon pricing uncertainty is likely to make financing of new base-load generation extremely difficult and is likely to drive investment in alternative peaking gas fired generation. DPI agrees that this is unlikely to represent an efficient long term investment solution that is in the interests of consumers.

At the same time, it is important to recognise that the regulatory arrangements and rules governing the energy sector should be allowed to evolve and improve over time to deliver efficiency improvements, whether this be in the competitive markets or through the regulation of network businesses.

DPI would also note that the AEMC has not included transmission risk and the inability of generators to hedge or manage intra-regional congestion risks in its discussion of regulatory certainty. These risks, which are discussed further below, are likely to have negative impacts on the investment environment.

Strategic Priority Two – Building the capability and capturing the value of flexible demand

DPI notes that the discussion within Strategic Priority Two focuses around capturing the value of flexible demand, but also discusses issues such as time of use pricing for residential customers and the broader roll out of smart metering technologies to these customers.

In this respect, it is important to set out up front the policy objectives associated with demand side management. Is the policy objective to capture the value of flexible demand and reduce the need for more generation and network investment through demand side contracting? Or is there a broader objective to promote cost reflective time of use pricing across all customers as a means of generating changes in behaviour and demand side response?

To the extent that the objective is restricted to capturing the value of flexible demand, this raises questions over the extent to which it will be cost effective for all customers, including residential customers to be able to enter into contracts with retailers, networks or other parties which capture the value of their flexible demand. It may be the case that most of the benefits associated with capturing the value of flexible demand lie with larger customers. DPI considers that clarification of the policy objectives and, potentially, further work to evaluate the optimal means of capturing the value of flexible demand would add value.

DPI would also note that some retailers may not have strong interests in promoting flexible demand side contracting. For example, gen-tailers that have significant levels of peaking generation in their portfolios may have few incentives to engage in demand side contracting if this reduces the value of their generation portfolio.

Notwithstanding this, DPI agrees that effective demand side participation should ultimately help reduce the need for more generation and network investment to meet forecast increases in peak demand. In addition, cost effective demand side participation should also provide important reliability benefits to the broader community.

Victorian smart meter project

The AEMC's discussion paper indicates that the Victorian Government has committed to requiring the rollout of smart meters into homes and businesses.

DPI requests that the AEMC's final strategic priorities document reflect the current status of the Victorian smart meters project.

In this respect, DPI notes that the Victorian Government has commissioned an independent cost-benefit analysis to determine whether, and under what circumstances, the smart meter program can deliver consumers value for money.

Separately, the Victorian Government is also undertaking a study into the potential impact on consumers should "time of use" pricing be made available. This study will consider how such pricing will affect the affordability of electricity for different types of consumers, including disadvantaged members of the community.

Strategic Priority Three – Ensuring the transmission framework delivers efficient and timely investment

DPI agrees that the delivery of timely and efficient transmission investment is a priority for the energy sector. The NEM is facing its most significant period of change since its commencement in 1998. The requirement for new investment in generation to meet load growth and the impacts of climate change policies have the potential to lead to significant changes in the patterns of generation across the NEM. This is likely to drive the need for significant investment in transmission networks.

As such, the regulatory and commercial frameworks governing network planning, and investment in the long term, and network operation and management in the short term, need to be robust to meeting these challenges.

DPI has already provided a submission to the AEMC in response to its 2010 Issues paper. Without repeating the points raised in the submission, it is worth making some comments on the Strategic Priorities paper:

Why is this priority important?

DPI considers that this priority is ultimately important from a consumer perspective. It is critical that transmission investment occur in the correct locations and in a timely manner. Under the open access framework that currently applies within the NEM, generators face the risk of being constrained off the transmission system where there is network congestion. Currently, generators have no means of hedging or managing the risks associated with intra-regional congestion and the ability to hedge inter-regional constraints is also limited.

As has been noted in the AEMC's Transmission Frameworks Review changes in the patterns and configuration of generation across the NEM could increase the risk of network congestion. Increasing levels of network congestion will hamper the ability of generators to access the market which in turn creates investment and operational risk for generation businesses.

The inability of potential generation investors to effectively manage or hedge against the risk of transmission congestion is likely to act as a barrier to obtaining generation finance and could therefore prevent efficient generation investment occurring. This is not in the interests of consumers who will bear the cost if the most efficient forms of generation cannot deliver their electricity to market.

As a consequence, DPI considers that both Priorities One and Three of the AEMC's report need to give recognition to the issue of transmission congestion risk, its negative impacts on a stable investment environment and the potential cost impact on consumers.

Connection queues and congestion

The strategic priorities document notes that queues for new connections that characterise some countries are not currently an issue in the NEM. It is noted that the queues that exist in countries such as Great Britain have been driven primarily by climate change policies and subsidies that are directly similar in nature to the Renewable Energy Target. Further, the issues in Great Britain are not limited to connections, but also include the presence of significant deeper network congestion as network augmentations have failed to keep up with the increasing demand for network capacity from the generation sector that has arisen in new locations, often remote from load centres. It is therefore important to reiterate that this cannot be characterised solely as a connections issue, with the problems facing Great Britain's networks relating more broadly to the network planning and investment framework.

In this respect, the potential for transmission congestion to increase in Australia, as a result of changing patterns of generation is a realistic possibility.

The key priorities

DPI considers that the planning, network access and investment incentive frameworks are critical areas for the review. Firstly, the significant changes in the configuration of generation across the NEM require consideration being given to further embedding a national approach to transmission planning. Secondly, consideration could be given to exploring an access rights framework that would enable generators to purchase rights to manage congestion risk in the short term and, in the long term, signal their demand for transmission capacity, in turn informing the planning process. Thirdly, the regulatory framework should provide more effective incentives on transmission businesses to respond to market demand for network capacity, both through efficient network investment and efficient network operation.

Consideration of gas market issues

DPI notes that the AEMC's Strategic Priorities Discussion paper is largely focussed on the electricity sector, with limited coverage of gas sector issues. To the extent that climate change policies drive the development of gas fired generation there will be increasing interactions with the electricity sector. In particular, it will be important to facilitate the development of liquid and transparent gas markets in the future, to enable parties, including electricity generators, to effectively manage their gas contracting and trading risks.

The development of short term gas markets in Victoria, Adelaide and Sydney represent important steps towards facilitating more competitive gas markets. However, consideration should be given to what barriers exist to the development of competitive markets going forward. This could include consideration of issues such as congestion and access to transmission capacity, and information transparency. It could also involve evaluating the likely impacts of increased exports of natural gas from Australia's east coast and the effects this is likely to have on east coast gas markets.

A failure to develop competitive and liquid gas markets could ultimately have profound consequences for the electricity sector. In particular, if market and regulatory failures exist in the gas sector this could lead to upward pressures on gas prices. At the margin, an illiquid and un-competitive gas market could also create security of supply issues in the electricity sector as gas-fired generation becomes more prevalent.

DPI would encourage the AEMC to devote more attention to the gas sector to assess what barriers exist to the development of competitive and liquid gas markets.

Yours sincerely,

Richard Bolt
Secretary

21 / 5 / 2011