

Strategic Priorities for Energy Market Development

2013

• A SUMMARY

The Australian Energy Market Commission is an independent, national body responsible to the Council of Australian Governments (COAG) through the Standing Council on Energy and Resources (SCER). We are the statutory rule maker for the energy market, and provide market development advice to federal, state and territory governments.

We are in a period in which the energy sector in Australia is subject to almost unprecedented interest and attention. This is understandable given large rises in electricity prices in recent years and the broader impact of the changing nature of our gas sector. The increased attention reinforces the need to remain focused on the longer-term strategic priorities for the development of energy markets, in the long term interests of consumers.



Our proposed new strategic priorities for energy market development are:

- Strengthening consumer participation while continuing to promote competitive retail markets;
- Promoting the development of efficient gas markets; and
- Market arrangements that encourage efficient investment and flexibility.

Since the release of our first strategic priorities in 2011 we've made substantial progress with many projects that have contributed to addressing them. We've completed a major change to the rules for electricity and gas network and access regulation. We've provided a final report to the Standing Council on Energy and Resources (SCER) for our Power of Choice review, and have concluded our Transmission Frameworks review. We're also undertaking a number of other reviews.

However, if consumers are to see the benefits of the work we've done to date, substantial implementation challenges remain.

Since many of the issues leading to the priorities established in 2011 remain appropriate, we've retained two of them, although we have shifted the focus to reflect more recent developments.

We're keen to generate as much debate as possible about these proposed strategic priorities. I strongly encourage you to contribute to this consultation by attending one of our workshops and providing a written submission. The validity and influence of our priorities will be greater if they take account of stakeholders' views and, as far as possible, represent a consensus. In particular we welcome comments about whether our new priorities accurately represent the key issues for the energy sector, over the short and longer term.

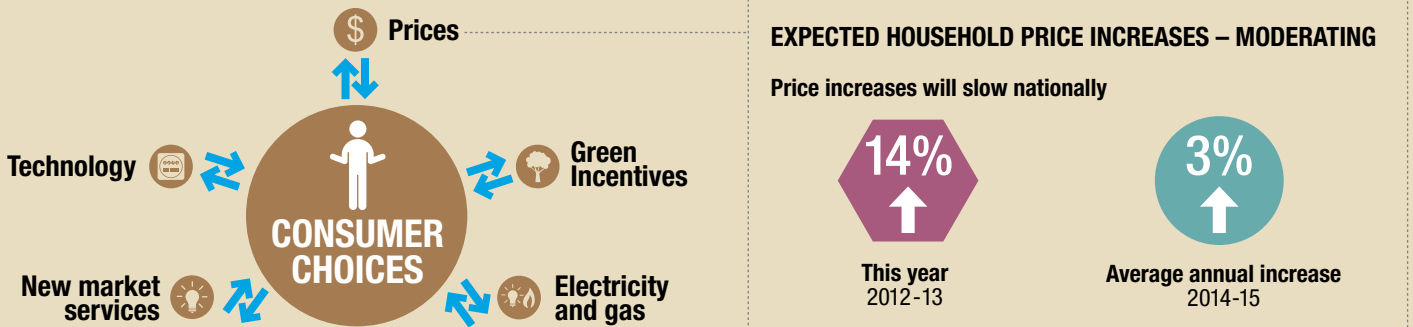
John Pierce
CHAIRMAN
AUSTRALIAN ENERGY MARKET COMMISSION

Our 2011 strategic priorities received feedback from consumer and gas sector representatives who felt that we'd not given enough priority to issues they considered most important for the future development of the energy sector. Our proposed new strategic priorities reflect this feedback and the debate around these issues.

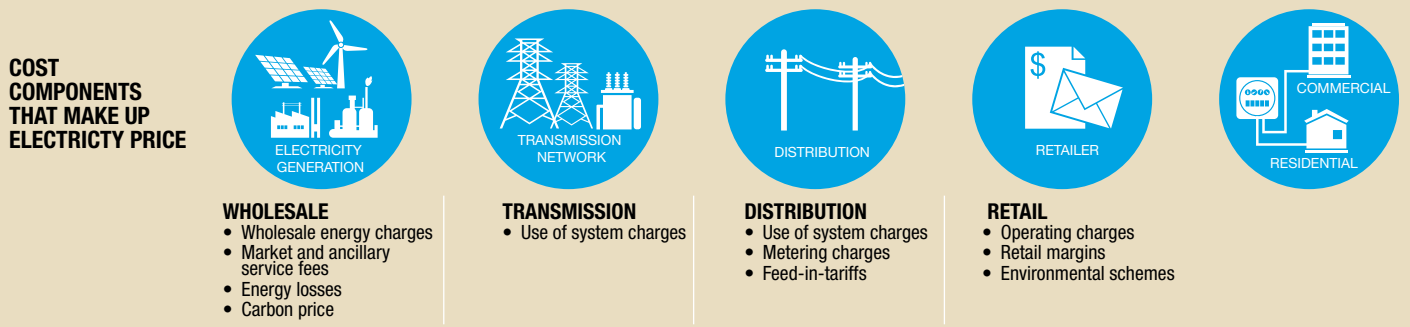
The Australian Energy Market in 2013

⚡ WHAT'S DRIVING CHANGE IN THE ELECTRICITY SECTOR?

People need information and tools to make energy choices that are right for them



Businesses need to find the most efficient investment options so that costs to consumers are kept to a minimum

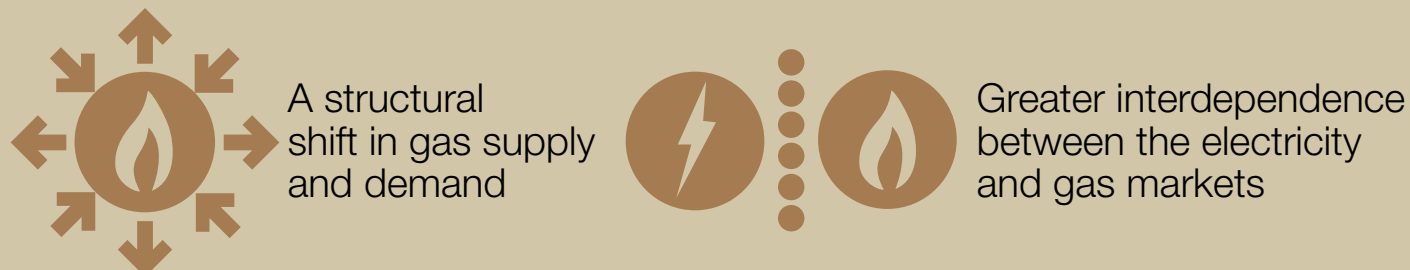


Because of Australia's big distances and small population, our energy sector is particularly capital intensive. Policy and technology uncertainty increases risks for investors, and each part of the supply chain presents unique investment challenges.



🔥 WHAT'S DRIVING CHANGE IN THE GAS SECTOR?

Two long term developments will influence the eastern gas market over the next few years:



The market needs to be resilient



FINANCIAL

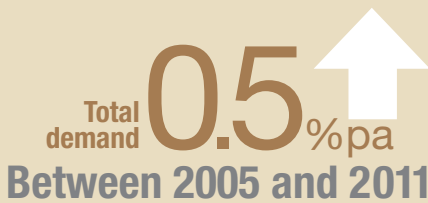
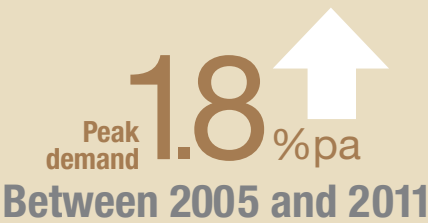
The electricity market's participants are financially interdependent through contractual arrangements. So far, this model has proven robust. But if a retailer experienced financial distress, continuity of supply could be threatened. The AEMC is currently reviewing the National Electricity Market's financial resilience to ensure consumers would be protected if a large retailer were to get into financial distress.



PHYSICAL

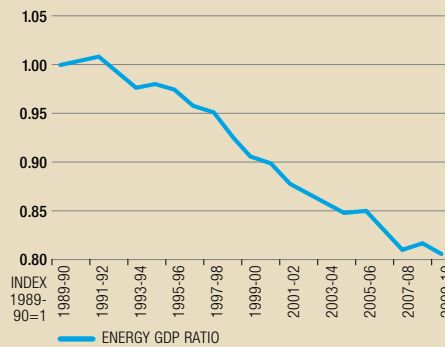
Changing demand and changes in generation costs have already impacted the technology mix. Renewable generation is growing. The increase in renewable and embedded generation means the market operator and network service providers will need to understand the potential implications for their roles.

The pattern of demand is changing, with implications for investment



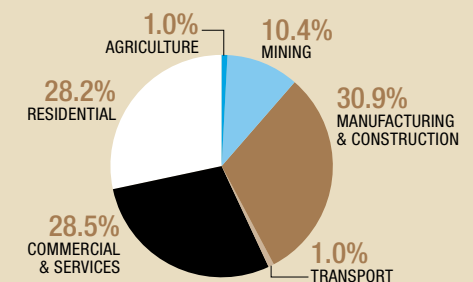
? Future

DECREASING RATIO OF ENERGY USED PER UNIT OF GDP IN AUSTRALIA



Source: BREE, Economic analysis of end-use energy intensity in Australia, Bureau of Resource and Energy Economics, Canberra, May 2012, p4.

AUSTRALIAN ELECTRICITY CONSUMPTION BY SECTOR – 2010-2011



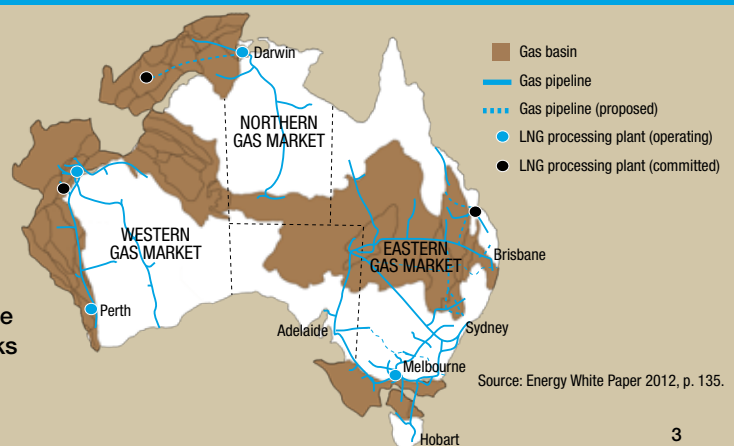
Source: Bureau of Resources and Energy Economics, 2012 Australian energy statistics data, Table F. Australian total final energy consumption, by sector, by fuel.

Australia's electricity consumption has steadily increased. But changes in the structure of Australia's economy and a growing services sector mean that the nation's energy intensity level is falling.

GAS DEMAND SET TO RISE



The eastern gas market will face challenges arising from the development of a Gladstone-based LNG export industry. This new industry will bring economic benefits. But it will test existing market structures' ability to meet domestic consumers' needs. We must examine the implications of these developments, and assess whether current market frameworks can continue to promote the efficient allocation of gas throughout the economy.



Strengthening consumer participation while continuing to promote competitive retail markets



Why is this important?

Effective consumer participation can contribute to a more efficient market and help consumers manage how much they spend on their electricity. It is vital for consumers to have choices in how they use energy and the types of energy services they receive. This proposed priority recognises the importance of a stronger role for consumers in energy markets and regulatory processes. It also recognises the role of competitive retail markets in safeguarding the long-term interests of consumers as we move to an energy sector that delivers services rather than just a commodity.

What are the issues?

If consumers are going to participate effectively in energy markets, they must have the right information and tools to make their consumption choices.

This priority also highlights the ongoing need for effective competition in retail markets, accompanied by appropriate consumer protections, to allow retailers to respond flexibly to consumer requirements.

There is also a role for stronger consumer participation in regulatory processes, such as network determinations, which can ultimately impact the prices consumers pay for electricity. We believe it is important to make it easier for consumers to engage in regulatory processes and the energy market.



We support initiatives to represent consumers' views in regulatory processes

How are we addressing this priority?

The AEMC, and other organisations, have already made considerable progress in addressing this strategic priority. Part of this work includes a comprehensive package of over 20 recommendations under the Power of Choice review, following extensive investigation of consumer and market issues. These recommendations were designed to support an evolving market, technological developments and changing consumer interests over the next 15 to 20 years. They aim to:

- Provide consumers with information, price incentives and technology – enabling them to see and be rewarded for efficient consumption choices; and
- Enable network operators, retailers and others to support consumer choice through better market incentives.

The AEMC will consider several changes to the national electricity rules this year at the request of energy ministers, to help progress the energy market reform agenda agreed by Australian governments in late 2012. Ministers are considering their position on a series of other recommendations we made under Power of Choice and our review of the energy market arrangements for electric and natural gas vehicles.

Other developments include the proposed development of the Consumer Challenge Panel and the establishment of a national consumer advocacy body by government and the Australian Energy Regulator. These bodies are being designed to promote greater consumer involvement in energy policy development, rule change processes and network determinations.

Another key strand of our 2013 work program that aims to promote greater consumer choice is our current review of the effectiveness of energy retail competition in New South Wales, Victoria and South Australia have already removed regulations on the setting of energy retail prices in the presence of effective competition. Energy ministers have requested our final advice on NSW competition by September 2013. This will include possible implementation strategies for the future removal of energy retail price regulation in NSW.

We believe that competitive retail markets, accompanied by appropriate consumer protections, will help to provide greater consumer choice and innovation in product and service offers. We expect the recent commitment of Australian governments to harmonise consumer protections in energy retail markets by no later than July 2014 will further improve overall protection for residential customers. The ACT, Tasmania, South Australia and Commonwealth have already adopted this important national reform.

Promoting the development of efficient gas markets



Why is this important?

Natural gas is a growing contributor to the Australian economy, both domestically and as an export commodity. In 2010-2011, gas accounted for 25 per cent of total primary energy consumption in Australia, growing annually by 5.6 per cent on average over the past five years. Australia's eastern gas market accounted for over half this consumption.

Australia's eastern gas market is undergoing a period of major development and change. The creation of a LNG export industry at Gladstone is expected to see annual east coast gas demand more than triple by 2017. There are increased opportunities for market participants to trade natural gas, with corresponding growth in the number of producers and buyers, and greater pipeline interconnectedness and flexibility. This will herald a new era of gas use.

What are the issues?

Structural shift in gas supply and demand

Australia's gas market structure has been characterised by bilateral trading between producers, pipeline owners and end users based on long-term contracts. This structure has supported the growth of the Australian gas industry by minimising costs and providing the certainty required for significant capital investments in production and pipeline capacity.

The establishment of the east coast LNG export industry is leading to a structural shift in supply and demand. While this shift will bring substantial economic benefits to the Australian economy, existing market structures will be tested in their ability to continue to meet the needs of domestic consumers efficiently.

Our proposed gas priority recognises the growing importance of gas as a fuel source and export commodity

Coinciding with the development of an LNG export sector, a number of contracts between domestic buyers and sellers of natural gas are due to expire. With the emergence of the east coast LNG industry, the traditional balance of power between buyers and sellers has shifted. Sellers of natural gas are now likely to have more leverage over buyers in contract negotiations and domestic buyers are facing the renewal of contracts at higher prices than in the past.

These changes raise the issue of whether more flexible and transparent mechanisms for trading wholesale natural gas are needed to enable participants to more efficiently manage their gas portfolios and contract obligations. Greater flexibility in trading may also result in a more efficient use of infrastructure, such as pipeline capacity, overall.

Greater interdependence between the electricity and gas markets

When the carbon price was introduced in July 2012, the share of gas-fired generation in electricity production was expected to increase significantly, leading to greater convergence between the electricity and gas markets. However, the most recent electricity demand forecasts from the Australia Energy Market Operator suggest that substantial new investment in generation capacity will not be required this decade. This means that further material convergence between electricity and gas markets may not be imminent. Nevertheless, it will be important to understand whether the gas market arrangements are fit for purpose in the longer term, in anticipation of increased convergence in the future.

How are we addressing this priority?

We're currently considering a number of rule changes that will help increase the efficiency of existing gas market frameworks.

In addition, during the first half of 2013, we will be undertaking a scoping study to review at a high level the existing gas market arrangements of the eastern states to understand the issues that may benefit from more detailed market development work. The scoping study will involve consultation with stakeholders and consider how and why the gas industry has evolved in the way it has. The AEMC will use the findings to inform discussions with SCER about potential future work to consider the efficiency of gas market arrangements.

The Australian Energy Market Operator (AEMO) is currently undertaking design and implementation work on a gas supply hub at Wallumbilla, Queensland, which was approved by SCER at its 14 December 2012 meeting. The hub will facilitate trading of wholesale gas close to production centres upstream from the STTM.

Market arrangements that encourage efficient investment and flexibility



Why is this important?

Market arrangements affect future investment decisions, and successful arrangements attract investment in the Australian energy sector at competitive rates. They provide:

- A relatively stable policy environment that is well understood by investors; and
- Flexibility to adapt, with transparent and well understood processes for policy changes.

Stability benefits consumers. It lowers the perceived risk of investing in the energy sector, which helps to lower financing costs and therefore the energy prices paid by consumers. It also makes investing in the sector more attractive, helping to ensure a stream of investment to maintain a reliable and secure energy supply.

On the other hand, markets have to adapt. Change will always be a feature of energy markets and the policy environment. There is uncertainty in any investment decision making. Good policy and regulatory arrangements change as knowledge develops.

The way in which change occurs is therefore important. It should be transparent, based on clear objectives and relatively predictable.


What are the issues?

The National Electricity Market (NEM) has in place an institutional and policy framework that has supported a consistent pipeline of investment to maintain a reliable and secure energy supply.

But investment requirements are changing. There will likely be a greater role for embedded generation and investments in new products and services to allow consumers more control over their consumption decisions. Significant investment will also be needed to meet the Renewable Energy Target (RET), and the introduction of a carbon price should provide incentives over time for investment in lower emitting generation capacity. As well, it will be necessary to attract capital to refinance existing debt to fund the generation and network assets that have already been built.

It will be important to build on Australia's institutional, regulatory and market framework to attract the capital necessary to fund future investment.

The development of Australia's stationary energy sector requires the careful and synchronised development of high level, economy wide policy and focused, market specific frameworks.



Consultation is
vital to manage
change efficiently

Transparent and objective policy, rule making and regulatory processes can help promote confidence among investors. The AEMC will continue to undertake projects that promote an environment conducive to efficient and timely investment.

The future focus is likely to be less about the quantity of investment, and more about policy frameworks that provide incentives to find the most efficient investment options.

How are we addressing this priority?

We're engaged in a number of reviews that will help to provide market arrangements to promote efficient investment. These include:

- **NEM financial market resilience.** We're reviewing the effectiveness of arrangements to deal with retailers who experience financial difficulties. We're considering whether changes are required to provide more confidence that, if large retailers get into financial difficulties, there will be no contagion effect that spreads to other retailers. We'll be making recommendations to SCER during 2013 about changes that may be needed.
- **National frameworks for transmission and distribution reliability.** This review will develop national frameworks for expressing, setting, delivering and governing transmission and distribution reliability. It's due to be finalised in late 2013. A more efficient and transparent approach to setting reliability levels will promote efficient investment in networks, because the need to meet reliability standards is a key determinant of network investment. Moreover, a more efficient and consistent mechanism for expressing reliability levels will improve the ability of the regulator to benchmark performance and determine efficient levels of network expenditure across the NEM.

- **Transmission frameworks review.** We made final recommendations to governments in March 2013 which aim to promote efficient coordination between investment in generation and transmission. The arrangements are flexible enough to deal efficiently with a range of possible scenarios for future patterns of generation and demand.

Successful implementation of two recent projects will be vital for ensuring that consumers receive value for money from investment in networks:

- **Network regulation rule changes.** The new rules improve the strength and capacity of the regulator to determine network price increases so consumers do not pay any more than necessary for the reliable supply of electricity.
- **National framework for electricity distribution network planning and expansion.** Large expansions of distribution networks will be subject to a new economic assessment. Network businesses will have to identify demand side projects that could meet future requirements more efficiently than network expansion.

We also participate in a number of other processes that affect the energy sector's investment environment. Our Chairman is a member of the Energy Security Council and we respond to and participate in consultations and policy development processes of a range of governments and other organisations.

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Consultation

We will hold three half-day stakeholder workshops in April and May 2013 to gather feedback on the strategic priorities proposed in this discussion paper, in Brisbane, Melbourne and Sydney.

Meantime we welcome written comments on this discussion paper, which are due by **27 May 2013**.

Submissions should quote project number EMO0025 and may be lodged online at www.aemc.gov.au or by mail to:

Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

All responses will be placed on the AEMC's website unless the response or a section of the response is clearly marked as confidential.