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Strategic Priorities for Energy Market Development

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (AEMC) Strategic Priorities for Energy Market Development Discussion Paper.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 34 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 59,000 people and contribute $24.1 billion directly to the nation's Gross Domestic Product.

The esaa broadly supports the priorities and areas of focus set out by the AEMC, but would like to take the opportunity to make some observations.

Consumer priority

Three areas of focus are proposed: Engagement, participation and protection. Each of these are important for vibrant competitive retail markets. There is a range of stakeholders that can make a contribution to these areas, including the industry, the AEMC, the AER, state and federal governments and consumer representatives. The establishment of Energy Consumers Australia is strengthening the latter group, which can have a particularly important role to play in the engagement of consumers.

Not all areas of potential concern are best addressed by a new or amended rule. As such, the AEMC's role in prosecuting this priority will be as much through its status as an expert body and disinterested party that can be a source of sound advice to governments and other stakeholders.

In respect of the participation focus, a key theme is the growing wedge between the actual cost of supplying electricity and the retail price. This wedge, caused by policy costs, will create problems over the longer term. To date the preferred method of underwriting renewables policy and energy efficiency is to recover costs through retail electricity prices. When this approach was first adopted it was less harmful than it is today. Previously it would make consuming electricity less attractive, at the margins, as the unit price was higher. But the overall impact was modest, as other than a small number of households with PV (or other distributed generation), all electricity was consumed from the grid.

Now that PV is a viable alternative for most households, pushing up the retail price to recover unrelated policy costs is distorting investment decisions. The grid is no longer a full monopoly and hence using power bills to fund policies creates winners and losers. This problem is likely to be exacerbated in the future as the cost drivers for electricity prices ease but policy costs continue to increase. It would be a perverse outcome if underlying costs are going down, but governments through their decisions continue to push up retail prices, leading to an overinvestment in technologies such as PV, which in turn increases policy costs. Since lower income households typically spend a greater portion of their income on energy than higher income households, these policy costs also function as a regressive tax.

As the energy transformation accelerates on the retail side, with household-level storage and electric vehicles amongst the emerging technologies, there will be an onus on policy makers to strike the right balance between facilitating new businesses models, imposing regulatory costs and maintaining consumer protections.

Just because the current regulatory environment is not ideally suited to a specific business model, does not mean there is a barrier to entry. If other businesses are able to provide the same service in a range of different ways, imposing costs on all market participants in the pursuit of facilitating a specific model is not warranted. The attitude of competition for competition's sake appears to have crept into some recent rule change requests, where the proposal is notionally designed to increase competition, but at a net cost to society (multiple trading relationships and demand response mechanism are examples where the costs appear to exceed benefits at the present time). In this respect, we welcome the scrutiny given to rule changes that emerged from the AEMC's own recommendations in *Power of Choice*, which we trust will result in rule changes only being approved where a net benefit can be robustly demonstrated.

Regulatory neutrality between existing businesses and new entrants will be an important issue, as innovation leaves society better off, regulatory arbitrage does not. Regulatory arrangements for new entrants are important because regulation is not free. Regulatory costs are borne by businesses and are ultimately passed on to consumers in higher prices. This becomes problematic when businesses providing the same service face different regulatory burdens. If consumer protection is achieved by only regulating the incumbents, this will allow new entrants to free ride.

Over the coming years there will be a range of new electricity retail products offered by both traditional businesses and new entrants. While these new choices for consumers should bring about better services and lower prices, it is important to get the balance right when attempting to regulate these new offerings. This does not necessarily mean that the same regulation should apply to all businesses or that the starting proposition should be the existing level of regulation. As part of this process policy makers and regulators should ask themselves: is the current regulatory burden still appropriate in light of the changing market dynamic?

The starting point should be the protections that apply under the Australian Consumer Law. Any burdens imposed over and above those that apply to all products needs to be justified on a cost-benefit basis. Where it is determined that an existing regulation applying to other electricity businesses is not appropriate for new entrants, policy makers and regulators should ask themselves if the regulation remains appropriate for any electricity business.

We recognise that the role the AEMC can play in this area may be complicated by limitations on its remit that means it does not have the powers to impose rules on some alternative energy services. This makes it especially important not to over-regulate the services that do fall within its remit,

Gas priority

Three areas of focus are proposed: Wholesale gas trading markets; pipeline capacity trading and information. We interpret these as ensuring the priorities are aligned with the existing work program.

This appears a sensible approach to defining the gas priority. Given the reviews are in train we will reserve detailed comments for the specific consultations. Suffice to say that the esaa in general favours an incremental approach to gas market reform that has due regard for existing property rights.

We note with interest that the AEMC has taken the trouble to specifically rule out gas and electricity market integration as a priority for the time being. This is understandable given the short to medium term prognosis for gas fired generation. But just as expectations of the level of gas fired generation have fallen rapidly, they could turn around quickly under different policy and commercial settings. We consider it important that the AEMC remains close to developments in the sector in order that issues may be identified early, noting that reform can be a slow process and that the consequence of market dislocation can be severe.

Markets and Networks priority

Three areas of focus are proposed: technology and new business models; network evolution and wholesale markets. We have commented on the first in the customer priority section above.

The second is the subject of several ongoing processes, notably: CSIRO/ENA’s Network Transformation roadmap, CEC/ARENA’s Future Proofing in Australia’s Electricity Distribution Industry and the COAG Energy council’s Strategic Assessment of Network Regulation. Accordingly, we recommend that the AEMC focuses on monitoring these initiatives and their outcomes prior to considering a major work stream of its own.

Wholesale markets remain a challenging area. As the AEMC has correctly identified, better integration of environmental and energy policies would be welcome. It is important environmental policy doesn’t undermine the operation of the price discovery mechanism in the National Electricity Market (NEM). As noted in the report, “over time, a properly functioning market is likely to be unsustainable when wholesale prices are not informing consumer choices in the retail market.” Arguably the Renewable Energy Target is already having this impact. Future environmental policies will need to find a way of being integrated with the wholesale market, rather than undermining it.

The integration of energy policy and environmental policy is one of the driving forces behind the transformation of the energy sector. The increasing penetration of intermittent generation raises the question of whether the current regulatory and market structures remain appropriate to both signal investment/disinvestment and allow for the effective operation of the physical market, including ancillary services.

The Australian Energy Market Operator (AEMO) is currently examining the implications of increasing penetration of intermittent generation on the operation of the market, particularly in South Australia. Their findings may require changes to the rules that govern the operation of the market and we support the AEMC and AEMO continuing to work together on these matters

In doing so, we note that AEMO's own analysis is (appropriately, given its role) focussed more on technical matters. As such there is an analytical gap in understanding the evolution of energy markets in the light of the changes in both supply and demand side technologies. For example:

- AEMO's assessments of when reserve capacity shortfalls may occur do not require them to evaluate whether new investment will be made in time to avoid these shortfalls.
- AEMO is obliged to treat certain contingencies as "non-credible" events because they are so defined in the rules. This includes contingencies such as failure of both lines of the Heywood interconnector, which has occurred 4 times in 16 years.
- AEMO's focus is on the operation of the physical market that it operates. Of almost equal importance in the context of investment (and disinvestment) is the hedging market.

Given AER's market monitoring is focussed on enforcement of existing rules, we believe AEMC is the NEM body best placed to fill this analytical gap.

Any questions about our submission should be addressed to Fergus Pope, by email to fergus.pope@esaa.com.au or by telephone on (03) 9205 3107.

Yours sincerely

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