13 May 2011

Mr Paul Smith
Senior Director
Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235

Dear Paul

Re Submission to AEMC Strategic Priorities for Energy Market Development

The Energy Users Association welcomes the opportunity to provide a submission to the Australian Energy Market Commisson's (AEMC) *Strategic Priorities for Energy Market Development* discussion paper. The EUAA has around 100 members including many of Australia's major electricity users. We have been actively involved in energy market issues since 1996 including many issues related to the original development of and subsequent reviews of the National Electricity Market as well as gas. We have also provided submissions to the numerous AEMC reviews including national energy markets in light of climate change policies, demand-side participation and the transmission frameworks review.

1. A predictable regulatory and market environment for rewarding economically efficient investment

The AEMC document says that minimizing investment uncertainty is an essential pre-requisite for efficient investment that minimizes costs to consumers. We believe that energy policy should focus on creating an environment that allows for investors (on the demand and supply sides) to have reasonable predictability and consistency on the direction of the market so that they can make decisions and allocate risk in the most efficient manner. This will tend to also serve to most efficiently limit investment uncertainty in the most efficient manner and at the lowest possible cost.

The AEMC states that governments need to be aware that uncertainty can be created if market participants perceive that policy settings will be changed regularly. Whist this is true up to a point, it could imply that even if policies are not appropriate (e.g. are not consistent with the National Electricity Objective), then maintaining the *status quo* is preferable in order to ensure investment certainty. In our view, the AEMC's approach should be balanced by such considerations. Sound energy policy development should also allow for some flexibility so that energy markets can adapt to new challenges, as well as allow market participants to have some certainty on its direction.

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2. Building the capability and capturing the value of flexible demand

The AEMC has said that it will be commencing a new review of demand side participation (DSP3) that will look across the whole supply chain to gain a further understanding of the barriers preventing the uptake of cost effective demand side flexibility. We support this broader approach and it is consistent with comments we have previously made to the AEMC, in terms of past submissions on your DSP review and in discussions on this as far back as 2008. We are pleased to see this broadened approach now being considered.

The EUAA and its members have been actively involved in promoting the development of DSP in the NEM virtually since its inception. This activity has included conduct of Australia's first demand side response (DSR) trial in November and December 2002. DSR case studies in five different industries followed the Trial which contributed directly to the formation of Energy Response Pty Ltd, Australia's first demand side aggregator. Our membership has often found that they experience frustration in dealing with retailers and network service providers (NSPs) if they seek to explore DSR opportunities. At times of high spot price events in the NEM, members have reported no (or reluctant) contact by either their retailers or by transmission and distribution service providers seeking DSR network support. This appears to have become more common as vertical integration of retail and generation activities has increased.

It is clear from our involvement in the previous two stages of the AEMC's DSP review that the NEM incentive framework is not enticing network businesses to take an active enough role in seeking DSR services from end-users. It may be prudent to offer incentives to end-users rather than to retailers and network service providers. If the outcomes from DSP3 maintain the *status quo* as the previous two reviews have, then it is unlikely that meaningful change will be achieved.

3. Ensuring the transmission framework delivers efficient and timely investment

We agree that the transmission network is facing new challenges from climate change policies and rising peak demand. In addition, it has always had a critical role as providing the backbone of the NEM; although its ability to play this role has been hampered in certain key ways (e.g. see the recommendations of the Parer and ERIG reviews, which have only partly been acted upon). We would like to see a more holistic and comprehensive approach to dealing with transmission issues that supports a more interconnected transmission system.

The AEMC points to its work on the RIT-T and the transmission frameworks review; and highlights some of the problems that have developed under the economic regulation framework of network service providers. The AEMC has said that as the RIT-T has only been operating for a short time it will continue to observe how it operates. The RIT-T is now the fourth iteration of the regulatory test since it was first developed around a decade ago. Very considerable effort has been invested in specifying the test over the last decade. We submit that there will always be some uncertainty about the costs and benefits of transmission investment as this is in the nature of the area. An even more detailed or precisely specified test, such as the RIT-T, does not make an uncertain cost or benefit any more certain.

4. Network pricing and regulation

Network pricing and regulation is a first order issue, comprising as it does, around half of the delivered cost of electricity to end users and a somewhat lesser amount in gas. It encompasses rules, institutions, governance and the National Electricity Rules. It also encompasses the policy role of the Ministerial Council on Energy, and policy at the state level in regard to government ownership and the setting of reliability standards for distribution and transmission network operators. The AEMC has a role through its rule change powers. This matter has now become so critical to energy users that we would like to see a comprehensive review of electricity network regulation which encompasses network regulation at the State and national levels and goes beyond the remit of the AEMC. We also note the recent comments calling for reform in network regulation by bodies such as the Garnaut Update Review and the Independent Pricing & Regulatory Tribunal (IPART).

Our members are very concerned with the design and implementation of NSP revenue controls.

AER decisions for the transmission network businesses in New South Wales and Tasmania see an average real increase in prices of 36 percent and 37 percent respectively over the current regulatory periods. The transmission price increases are the result of the growth of revenues and regulated asset bases that seem far out of proportion to the modest growth in energy transported or peak demand satisfied. The four distribution reviews undertaken by the AER have resulted in state-wide real average price nominal increases of 80 percent in NSW, 54 percent in Queensland, 30 percent in Victoria and 54 percent in South Australia over the current regulatory periods.

The reasons often cited for increased expenditure for the distribution network businesses is to meet rising peak demand and the need to replace ageing assets. This is the reason used by the AER to justify its approval of large increases in capex relative to the previous regulatory period. Allowed expenditure increases enlarge the asset bases of the distribution businesses. Coupled with high rates of return, the result is higher allowed revenues and higher prices. Research has also found that Australia's productivity has declined significantly since the 1990s[1] with multi-factor productivity in the utilities sector declining by approximately 3.6 percent from 2000/01 to 2009/10.[2] Electricity is the largest component of the utilities sector and monopoly electricity distribution networks are the largest proportion of the electricity industry.

We do not doubt that some expenditure to replace ageing assets and to meet peak demand is necessary; however, recent work for the EUAA to be published shortly has found that there are other factors behind the large network price increases that electricity users have experienced recently.

The current regulatory regime fails to account for Government ownership, the 'propose-respond' model has turned the onus of proof in regulatory resets away from network service

[1] Saul Eslake & Marcus Walsh, *Australia's Productivity Challenge,* Grattan Institute, February 2011 p. 4
[2] Ibid p. 23

providers, the AER has not benchmarked network expenditure proposals as required under the Rules, excessive rates of return have been allowed, and the appeal mechanism is not providing a level playing field and encourages 'cherry-picking'. We note that the AEMC has highlighted the appeals process and the additional revenue increases granted by the Australian Competition Tribunal as being a problem. We support a review of the current arrangements in regard to Australian Competition Tribunal appeals, the need for which has also been raised by others such as IPART. However, as mentioned above, we would see this as part of a wider review of the rules and other aspects of the regime under which network service providers are regulated. This review should be undertaken as soon as practicable and certainly before the next round of transmission and distribution network reviews takes place. As mentioned above, it would seem timely and most efficient that a comprehensive review of all aspects of network regulation is undertaken at once and we feel that this would best be done by an independent body that has a broad remit and relevant expertise to examine all relevant matters.

We would be happy to answer any queries that the AEMC might have.

Yours sincerely,

Roman Domanski
Executive Director