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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Dear John

STRATEGIC PRIORITIES FOR ENERGY MARKET DEVELOPMENT

The Business Council of Australia (BCA) welcomes the opportunity to comment on the strategic priorities for energy market development for the Australian Energy Market Commission (AEMC). The BCA is an association of the CEOs of around 100 of Australia's leading corporations with a combined workforce of over 1.2 million people.

The BCA's primary focus in this submission is on the policy settings that impact on the energy market. While the AEMC's primary role is as rule maker and developer, we also note its role in providing strategic and operational advice to the Ministerial Council on Energy (MCE). For this reason, we have taken the opportunity to reflect on the recent progress of energy market reform and the policy settings that will promote a more efficient national energy market.

The existing energy market reform agenda, which the MCE has responsibility for, has been largely overshadowed by the ongoing debate regarding carbon pricing, and has progressed slowly since 2007. However, continued momentum on energy market reforms is now more important than ever. Having an efficient and effective energy market will be one of the most important steps that the government can take in maximising the pool of potential investors that will help to meet the investment task ahead.

We believe it is now critical that the AEMC's efforts in promoting an effective national market are complemented by a more consistent commitment across governments to the disciplined and timely implementation of the energy market reform agenda.

As a first step, COAG should initiate an independent review of the implementation of energy market reform. The Energy Reform Implementation Group (ERIG) recommended such an independent review of implementation in its 2007 report. While the COAG Reform Council (CRC) currently reviews the progress of energy market reform under the seamless national economy agenda, this is a partial picture of progress, hampered by the relatively unambitious scope and timing of reforms in the implementation plan. The review would not only assess the progress of reform to date but also outline the appropriate scope and timing for completing unfinished energy market reforms.

The BCA suggests three areas for priority attention in completing unfinished energy market reforms:

1. Enhancing national market regulation and competition (including closing off remaining regulatory anomalies that work against a seamless market and monitoring the effectiveness of regulatory structures).
2. Facilitating greater demand-side participation.
3. Removing retail price regulation.

The BCA has consistently supported ongoing reforms in these areas and is pleased to note that these issues are raised in the AEMC's discussion paper.

The importance of an effective market

The AEMC's discussion paper on its strategic priorities has effectively captured the critical backdrop for its future work on market design in the Australian energy sector. In particular, the market will need to support an unprecedented level of investment in generation capacity over the next decade to maintain reliability and security of electricity supply, while at the same supporting a transition to lower emissions as a result of the government's climate change policies.

Estimates of the investment in electricity sector generation and transmission required to meet future demand and move to lower emissions technology range from $72 billion to $82 billion over the next 20 years. This estimate does not include the costs associated with new distribution networks, greater use of gas and related infrastructure.

The primary objective for energy markets now and in the future is quite clear. The energy market should facilitate the adoption of the optimal mix of supply and demand-side technologies at the lowest possible cost to ensure that our energy supply is reliable, affordable and supports our transition to a low-carbon economy. The Department of Resources, Energy and Tourism's recently commissioned work by the Electric Power Research Institute on the costs of various technologies for electricity generation out to 2030 will serve as a useful guide in continuing to assess the progress of Australia's energy market in facilitating this outcome.

In transitioning to this optimal mix of technologies over time, it will be critical that market interventions are carefully designed and implemented. In addition, any underlying vulnerabilities in the market settings should be addressed now to ensure a smooth transition rather than one subject to unnecessary shocks.

As conveyed throughout the AEMC's paper, having an effective energy market has significant benefits in the current environment. Competitive wholesale and retail markets provide opportunities to identify the most cost-effective ways to provide services and encourage participants to seek opportunities to reduce the costs that feed through into efficient prices. An effective market can also identify the most efficient ways to reduce externalities such as carbon emissions when their interactions with energy markets are considered.

The BCA has adopted six key principles for Australia's infrastructure markets, including our energy sector. These principles were developed as part of the BCA's *Infrastructure Action Plan* in 2005 and remain highly relevant in considering the market settings that will be most conducive to competitive and efficient outcomes in the energy sector.

1. Effective national (not state-based) infrastructure markets, including national or uniform regulation.
2. Market-based prices that send the appropriate signals to consumers and suppliers (cover long-run marginal costs, reflect time of use).
3. Public investment processes that are integrated across governments, forward looking, based on consideration of all options and favour projects with the highest (and published) benefit–cost ratios.
4. Effective competition in all contestable market segments.
5. Private ownership as the preferred model in all contestable market segments.
6. Regulation of infrastructure that does not discourage investment seeking to meet expected demand.

Progress of energy market reforms

Australia was one of the first countries to undertake broad structural reform of its energy markets, with the reforms being lauded internationally by groups such as the Organisation for Economic Co-operation and Development. The structural reforms undertaken to date are consistent with the BCA's principles and include the creation of a national market, the disaggregation of generation, transmission and distribution, the introduction of full retail contestability and sale of public assets in some states.

Numerous studies have highlighted the significant benefits of this history of reform. While it is difficult to draw simple conclusions about performance across the whole National Energy Market (NEM), the evidence broadly suggests that the reforms undertaken up until 2007 resulted in increased productivity in the electricity sector and falling retail prices. At a whole-of-economy level, the creation of the NEM alone was credited with adding $2 billion per annum to GDP in 2002.[1]

The progress of energy market reform in response to the report of ERIG in 2007 has been much slower than previous reform efforts. While COAG did not explicitly agree to every recommendation of ERIG, its recommendations provide a good benchmark for the fundamental conditions required for a more efficient and effective national electricity market. The table at Attachment 1 provides a summary of progress against the main elements of proposed reforms.

An assessment of the progress of reform since 2007 suggests that:

- There has been significant progress in moving to a system of national governance and oversight of the energy industry with the establishment of the Australian Energy Market Operator, increased role and resources of the AEMC and transferral of regulatory functions to the Australian Energy Regulator (AER).
- There has been limited privatisation of government-owned assets across the network. For example, around 50 per cent of generation capacity is government-owned as well as the majority of transmission and distribution providers.

[1] Commonwealth of Australia, *Towards a truly National and Efficient Energy Market*, 2002, p. 251.

- There continues to be fragmentation of regulatory responsibility and persistence of inconsistent and inefficient regulation including state-based retail price regulation in all jurisdictions except Victoria, derogations from national energy rules and multiple state-based renewable and energy efficiency programs (e.g. the Prime Minister's Task Group on Energy Efficiency identified almost 300 individual energy efficiency measures).
- Limited meaningful steps to increase demand-side efficiency with a disproportionate focus on costly and relatively ineffective energy efficiency obligations as opposed to practical steps to measure and price energy at more frequent intervals and embed incentives for efficiency in the market.
- There is no comprehensive and transparent review of the progress of energy market reform on an ongoing basis, as highlighted by the CRC.

The slow progress to date is largely the result of an inconsistent level of commitment across state governments to reform the remaining elements of the energy market for which they have responsibility. Reports from the CRC on the Seamless National Economy reform agenda have suggested that COAG's commitment to energy reform is unclear. For example, in 2008–09 it recommended that COAG clarify its agenda in the area of energy reform with a view to establishing a more coherent set of outputs and milestones.[2] At the same time, the Commonwealth Government appears to have limited leverage to progress these reforms through the COAG agenda, in contrast to other regulatory priorities where COAG has placed greater emphasis and there is reward funding is at stake.

Reform priorities for a more effective market

The limited progress of further energy market reform may not be resulting in the market signalling great unease at this point. However, risks and vulnerabilities in markets can persist for a long period without major consequences but can become severe and even intractable in the event of market shocks.

In the period ahead as the economy transitions to a carbon price, there will be a need for this price to translate into the right signals and investor confidence in the NEM to bring about the unprecedented level of investment required. Even if this transition is managed carefully, there will be heightened risks of price and supply volatility. Apart from a careful transition process, the best way to manage these risks is to ensure that the market is as efficient and competitive as possible.

An effective reform agreement and reporting regime

The CRC has previously suggested that its annual reporting is merely a partial picture of energy market reform progress. The BCA considers that there is a case to bring together an integrated and more comprehensive progress report on an annual basis. This could be undertaken through existing processes by the CRC, but would require a more detailed implementation plan to which all jurisdictions commit and that covers the full scope of energy market reform.

In order to establish a firmer agreement and more appropriate benchmarks for the CRC's reporting, COAG should initiate an independent review of the implementation of energy market reform. The Energy Reform Implementation Group (ERIG) recommended such an independent review of implementation in its 2007 report. The

[2] COAG Reform Council, National Partnership Agreement to Deliver a Seamless National Economy: Report on Performance 2008–09, 2009, p. xxi.

review would not only assess the progress of reform to date but also the appropriate scope and timing for completing unfinished energy market reforms.

Enhancing national market regulation and competition

The BCA considers that there is a need to close off remaining anomalies that work against a seamless national market as well as monitoring and reviewing existing regulatory structures to ensure that they remain efficient in the face of new market risks. The BCA is encouraged by the fact that in many of these areas, there is already work underway, including through reviews conducted by the AEMC. However, disciplined and timely implementation by governments is now necessary to finalise these reforms.

Derogations from energy market rules

Over four years since ERIG, state derogations from national market rules are yet to be reviewed and removed. Reviews of energy market derogations are due to be completed by the middle of 2014. These reviews will not commence until after the introduction of the National Energy Customer Framework in the middle of 2012.

At the same time, many actions taken by state governments since 2007 are actively working against a seamless national market. For example, Victoria has recently sought to expand its energy efficiency target on retailers despite the Commonwealth Government's pursuit of a national energy efficiency obligation and the ongoing process of developing a price on carbon. In addition, the National Energy Customer Framework is unlikely to be consistent across jurisdictions, with the CRC reporting that states intend to implement this framework according to their own preferences.

Network Efficiency

Investment in transmission and distribution assets needs to be timely and efficient. Over-investment could lead to unnecessarily high prices, while under-investment could lead to unreliable supply and constrained generation competition. Identifying the appropriate balance across the network is a complex task, especially as the mix of generation technologies moves towards renewable and low-carbon generation. The AEMC's review of transmission frameworks and the AER's review of its regulatory frameworks for network price determinations will be critical in ensuring that this balance is right in the future.

Managing wholesale price volatility

The AEMC's discussion paper raises the issue of the implications for the contract market of changing market structures, and in particular, vertical integration of generation and retail activities. While such integration is a legitimate means of managing the risk of wholesale price volatility, it has the potential (as the AEMC's paper points out) to undermine liquidity in the contract market, which would increase barriers to new generators entering the market and limit options for independent retailers to manage their risks. The BCA acknowledges the difficulty in developing appropriately balanced policies to address this issue but supports the MCE and AEMC monitoring this risk on an ongoing basis.

Measures to facilitate greater demand side participation

As highlighted previously, the energy market should also facilitate the adoption of effective demand-side technologies. The benefits and opportunities in this area are highlighted by the fact that peak demand growth has been exceeding overall demand growth (3.5 per cent compared to 1.2 per cent since 2005). The result is greater capital expenditure in generation and network assets for very limited occasions during the year, leading to higher prices across the entire network.

In eliciting greater demand-side activity from residential users, there appears to have been a disproportionate focus on formal energy efficiency programs. The BCA has previously highlighted its concerns with the effectiveness of programs that provide financial incentives for energy efficiency to consumers while placing an obligation on energy retailers.[3] If demand-side participation is to play its part in increasing the efficiency of investment then it must be effectively integrated in the market to draw on the incentives of providers and consumers without being unnecessarily burdensome or complex. This requires two steps:

- As a first step, energy needs to be able to be measured, priced and controlled in real time. To date, the rollout of smart meters by states has been slow and in Victoria where it has occurred, implementation has not been geared to the needs of consumers. Retail price regulation also remains in place for the majority of consumers across Australia, limiting flexibility around the use of different tariffs. Installing smart meters and lifting retail price regulation will not of itself deliver greater demand-side participation but it is an important foundation.

- These foundational measures will then give electricity retailers the flexibility and capability to develop and introduce new interfaces and packaged products that allow consumers to more seamlessly manage their demand. This is beginning to take place through pilots of new consumer interfaces by energy retailers in areas with smart meters.

Business will also seek to manage its demand where it is economic to do so. In this regard, it will be important that there are not undue barriers to flexible demand contracts. We believe that the MCE-commissioned Stage 3 review of demand-side participation will assist in more clearly defining the actions that must be taken by governments as well as the incentives, information and market settings necessary to facilitate greater demand-side participation. However, the issue remains that there are practical steps governments can take now that will position the market to take greater advantage of demand-side management in the future.

Removing retail price regulation

The BCA has consistently called for retail price regulation reviews to be brought forward by governments and the removal of retail price regulation to be expedited. Unfortunately, all jurisdictions except Victoria continue to regulate retail prices. The AEMC reviews of this regulation in each jurisdiction are scheduled for completion by the middle of 2014. However, even if the AEMC recommends the removal of retail price regulation, state governments may choose not to heed this recommendation, as demonstrated by South Australia's response to the AEMC's recommendation in 2009. It is not surprising therefore that the CRC has requested COAG to clarify its

[3] See the BCA submission to the Prime Minister's Task Group on Energy Efficiency at: http://www.bca.com.au/Content/101809.aspx.

commitments on removing retail price regulation in electricity and natural gas markets.[4]

The AEMC's reviews undertaken to date have clearly demonstrated the adverse impact that an inappropriate retail price level can have on the efficiency of the market. If prices are set too low then there are inadequate incentives for investment and innovation, which can lead to insufficient and poor quality energy supply in the future. If prices are set too high, there are few incentives for firms to provide the lowest price to consumers, which they would otherwise provide in an unregulated market.

Up until recently, the persistence of retail price regulation has not resulted in any major adverse events in the market. However, during the 2008 financial year, the wholesale market faced significant pressures from both the drought and the withdrawal of state government-owned energy businesses from the investment market for new plant. These shocks to the market resulted in wholesale prices being much greater than retail prices and led to the collapse of an energy retailer in New South Wales.[5]

There is also international evidence that the prerequisite for lifting retail price caps – effective and workable retail competition – already exists in many Australian markets. As highlighted by the AEMC, an international study by VassaETT assessed the Queensland, New South Wales and South Australia markets as having characteristics that demonstrate they could be amongst the top 10 most competitive retail electricity markets in the world. This further underlines the potential for removing price caps in these markets.

The AEMC's most recent review of retail price competition in the ACT demonstrated that even in the absence of effective competition at this point in time, practical steps can be taken by states now to improve the efficiency of retail markets, such as disseminating information to consumers.

The Productivity Commission has also highlighted its support for the removal of retail price regulation.[6] It suggested that where it remains in place it would need to facilitate the pass-through of the carbon price to energy consumers, which would present methodological difficulties for the setting of retail tariffs.

Given these concerns around retail price regulation, it is not surprising that it is a significant risk for potential investors. The investment task ahead underlines the need to reduce this barrier to investment.

The BCA commends the AEMC on setting out its strategic priorities and engaging stakeholders through this process. We look forward to continuing to engage with the AEMC in this critical area.

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[4] COAG Reform Council, National Partnership Agreement to Deliver a Seamless National Economy: Report on Performance 2009–10, 2010, p. xxix.

[5] See P. Simshauser and K. Laochumnanvanit, *The Price-Suppression Domino Effect and the Political Economy of Regulating Retail Electricity Prices in a Rising Cost Environment*, AGL Applied Economic and Policy Research, January 2011.

[6] Productivity Commission, *Annual Review of Regulatory Burdens on Business*, 2009, pp. 135–136.

I have also copied this letter to the Commonwealth Minister for Resources, Energy and Tourism in his capacity as the Chair of the Ministerial Council on Energy.

Yours sincerely

Maria Tarrant
Deputy Chief Executive

cc The Hon Martin Ferguson MP, Minister for Resources, Energy and Tourism

Attachment 1. Summary of Energy Market Reform Progress against ERIG principles

Area of Reform	Progress Indicator	Explanation
Market Governance		• Significant steps have been taken, including establishment of the Australian Energy Market Operator, increased role and resources for AEMC and transferral and some regulatory functions to AER.
Investment Environment		• Continued retail price regulation in all states (except Victoria), which distorts critical investment signals. • There remains a predominance of government owned businesses in the energy market with the potential for an advantaged position relative to private sector investments. For example, 50 per cent of generating capacity in the NEM is owned by state governments. However, these businesses have withdrawn from the market for new plant.
Demand Side Efficiency		• Household and small business consumers are yet to be presented with a compelling and simple package or product that encourages more efficient electricity use. • Greater demand side participation remains extremely difficult in an environment where the majority of energy use is not capable of being measured, priced and controlled in real time. • While some state governments have introduced energy efficiency obligations and the Commonwealth Government is considering a national energy efficiency obligation, these initiatives are generally costly and poorly target incentives of various parties. • The recently announced Stage 3 Demand Side Participation Review that will extend beyond the National Electricity Rules should provide an important contribution in this area.
Ongoing evaluation and reporting of energy market reform		• ERIG recommended an independent review of the implementation of energy market reform. This has not been undertaken to date. • The COAG Reform Council has suggested that the reporting of energy reform it undertakes under the seamless national economy agenda is a partial and unrepresentative picture of energy reform.
Seamless National Market		• Numerous state-based renewable energy subsidies and energy efficiency obligations (eg. the Prime Minister's Task Group on energy efficiency identified almost 300 energy efficiency measures). • Review and removal or harmonisation of state derogations from existing market rules has been delayed. Reviews are set to be completed by June 2014. • Continued fragmentation of regulatory roles with Western Australia and the Northern Territory who are subject to state-based regulatory authorities and continued role of state regulators in retail price controls in every state except Victoria.
Reliability and efficiency of supply		• The first National Transmission Network Development Plan (NTMDP) has been published by AEMO. • At the direction of the MCE, the AEMC has been undertaking a transmission frameworks review and has completed a review on the framework for network planning by distribution businesses. • AEMC has undertaken a review of energy market frameworks in light of climate change policy. • Retail price regulation continues to distort generation investment decisions.