Western Australia's Electricity Market – at a Crossroad

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> More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly."
>
> Woody Allen

Introduction:

Thank you to the Office of Energy and the AIE for the opportunity to talk to you today. Wayne and Murray were generous enough in the topic they gave me to allow me considerable flexibility in what I could discuss. Consistent with that, I have chosen the topic "Western Australia's Electricity Market – at a crossroad" because I think now is a good time to reflect on what electricity reform was supposed to be about and whether or not we are still on track.

Those of you who know me will also know that I am generally an optimist (and as a Docker's supporter that is becoming easier), but I have taken the Woody Allen quote as a starting point because I think the debate around electricity reform (and, in particular, the response to climate change) has become so confused and dominated by particular vested interests that we are at risk of losing sight of the overall objective – what is in the best long term interests of consumers – and that given the confused and confusing state of the current debate it is not surprising that sometimes it does look like we are faced with Woody Allen's choices. If we are to make wise choices then we need to have an informed debate with a focus on the broad community interest.

I want to discuss a number of current issues in the market but I want to do that in the context of what we all saw, when we embarked on this reform agenda, as what a well functioning electricity market would look like. I will then make some comments on current issues in light of these "principles".

As you know the ERA has a role in monitoring the performance of the market and that we provide an annual report to the Minister on how the market is performing. That report will go to the Minister in the near future and will become publically available. It will deal in more detail with some of the issues I will touch on today. As the Authority still has to sign off on that report, the comments I make today should be seen as my views and not necessarily those of the Authority.

A final introductory comment. The ERA's vested interest in all of this is the long term interests of Western Australians and that means that the overall objective should be one of economic efficiency.

What was reform about?

The underlying assumption behind the reform agenda was that transparent competitive markets were most likely to provide the best outcome for electricity consumers (in contrast to the then government owned vertically integrated monopoly). This required that:

- There was a disaggregation of Western Power;
- Government interference in the market was to be kept to a minimum and where there was no potential for competition (networks), there should be independent regulation rather than government regulation;
- In the interests of economic efficiency, cross subsidies would be removed and CSO's would be made transparent;
- There was cost reflectivity at all levels in the supply chain including retail tariffs; and
- There would be a move to full retail contestability as soon as possible.

The focus was on the development of a "workable" market model tailored to WA's particular circumstances. So we had constraints on the major market players Synergy and Verve (e.g. the prohibition on Synergy being a generator or Verve being a retailer, the cap on Verve's capacity and the vesting contract to encourage new competitive sourcing opportunities and to limit the exercise of market power). We also took a cautious approach (e.g. we had both a capacity and an energy market and we had an unconstrained approach to the network).

Looking at that list the conclusion that can be reached is that we have come a long way but we still have a considerable distance to travel before consumers can see the full benefits of the reform agenda. It is my view that we are currently at a point where decisions made over the next twelve months will be important in determining whether those gains are achieved or not. And not all the signs are encouraging!

The Role of Governments

There is a long way to go before we have minimum interference in the market from governments – either State of Commonwealth. For the private sector to invest it needs policy clarity. I doubt that there is anyone who would argue that they currently have clarity about the energy policy and objectives of either the State or Federal governments.

Let me be clear as there are various views about what an energy policy might be – indeed this is made clear in the various responses to the Strategic Energy Initiative. As I have said previously on two occasions to forums conducted by the Office of Energy and the AIE, if the Government was to have an industry policy which has as its objective to remove impediments or obstacles that might get in the way of the market operating efficiently, then that would be a good policy. On the other hand, if it is about interfering in the marketplace in response to particular vested interests, then that is unlikely to be of benefit to consumers.

In my view the SEI *Directions Paper* has a bet each way. It starts well with the first

and second principles being:

> "*Markets with efficient regulatory frameworks are the preferred mechanisms for the supply of energy and the associated infrastructure and services*"
>
> *"Government will intervene in energy markets ONLY (my emphasis) to the extent necessary to ensure public safety and address demonstrated market failure"*

Two good starts although with respect to the second, demonstrated market failure is a necessary but not a sufficient reason for intervention – the benefits of the intervention must outweigh the costs!

The problem is that the remaining four principles are broader justifications for the government to interfere in the market place.

We don't have to look too far to find poor examples of government interference in the market place. If we are to reduce our reliance on fossil fuels and to increase the use of renewable energy then we need to realise that (with current technology) we will face increased costs. Given that current energy costs are already seen as high and causing financial distress to at least some consumers, we have a responsibility to make the transition in the most cost effective way. (Despite political promises, there is no magic pudding here – the higher costs will be met by consumers and/or taxpayers!)

There are a range of subsidies that are provided by both levels of government to renewable energy sources that are resulting in the development of inefficient energy sources. There have been a number of independent reports into schemes such as the Commonwealth Solar Home and Communities Program and WA's Feed-in Tariff scheme which have suggested that the cost of the CO_2/tonne saved by these types of schemes has ranged from $195 to $640 (and this has usually just been based on the direct costs without allowing for any impact on network costs). These very high costs (no one has suggested the need for a carbon price at these levels) are ultimately paid for by energy consumers and/or taxpayers. Such schemes appear to be popular (which is why governments have introduced them) but would they still be popular if the direct beneficiaries were bearing the full cost. (As I have said on another occasion, this is middle class welfare at its worse.)

The most recent evidence on the adverse impact of these inefficient green schemes comes from the draft report from the NSW Independent Pricing and Regulatory Tribunal (IPART) regarding retail electricity prices in NSW released last week. It is worth quoting:

> *Looking at the overall drivers of these 18% price increases, the main reason that electricity prices are increasing is that network costs are increasing significantly adding 10% to final prices, consistent with our decision last March. Since then, green schemes have emerged as a new driver of price increases, with the Federal Government's RET scheme adding 6 percentage points to prices.*
>
> *Green scheme costs reflect the costs of complying with various mandated government schemes designed to mitigate carbon pollution. These costs have increased four-fold since 1 July 2010.*

Most of the increase in green scheme costs stems from the Federal Government's Renewable Energy Target (RET) scheme. This scheme is designed to ensure that 20% of Australia's electricity supply will come from renewable sources by 2020. On 1 January 2011 the Federal Government split the scheme into a large scale Renewable Energy Target (LRET) and a small scale Renewable Energy Scheme (SRES). The costs of complying with this scheme have increased significantly since 2010. This is influenced by the financial incentives offered by State and Federal Governments to install solar panels, which qualify for a subsidy under the RET.

We remain concerned that high cost abatement has been promoted through Federal and State Government schemes and, as a result, electricity customers and taxpayers are paying more than necessary.

The Chairman of IPART, Rod Sims summed the situation up well in his comments on the draft decision in the Financial Review last Friday. Mr Sims said:

"If we are going to take measures to deal with greenhouse issues we have to do it at lowest cost. The RET scheme is not the lowest-cost, it is a scheme where governments are determining how we reduce emissions and that is not as efficient as if we leave it to the market, so I think the sooner the RET scheme is phased out the better."

There is currently a lot of discussion about the impact of a carbon price on electricity costs. What tends to be overlooked is that there is already a mandatory renewable energy policy that is one of the main contributors to cost pressures on retail prices.

The point is that when governments interfere in the market (even with the best of intentions) it can have unintended consequences. In the case of the subsidies for PV, higher costs of renewable energy than is necessary is one of the unintended consequences (there are and there will be others). It would be reasonable to assume that governments would have learnt from the experience of the home insulation scheme. A first year microeconomics student would have been able to predict what was going to happen. If you artificially create a market there will almost inevitably be unintended consequences. Perhaps the only good thing to come out of the very expensive home insulation scheme is that it has given economics lecturers a great case study in government policy failure and unintended consequences.

Finally, with respect to the role of Government, I have to repeat comments I have made previously that I am still not convinced that the current State Government is committed to a competitive, transparent electricity market. There are a number of reasons for this and they include:

- The lack of transparency around the replacement vesting contract;
- The replacement vesting contract lacks the pro-competition features included in the original vesting contract, in particular the displacement mechanism and the associated information provision by Synergy to the market, i.e. the displacement statement of opportunities;
- The absence of a clear policy framework for increasing retail competition (including cost reflective retail tariffs and full retail contestability);
- It is also important that any government intervention in the market place is

done in a very transparent way. It is of concern when projects partly funded by the taxpayer, such as the Verve Mid-West Solar Project are not the result of an open expression of interest process. How does the taxpayer know that they are getting best value for their "research" dollar in the absence of such a process?

The State Government needs to signal to the market its support for establishing as much competition and transparency in the market as is possible and to indicate that any interventions will only be in response to proven market failure and where the benefits of the intervention exceeds the costs. Otherwise, market confidence could be undermined putting timely private sector investment at risk.

Cross Subsidies, CSO's and Cost Reflectivity

There is one major cross subsidy that is inconsistent with the original objectives of reform. Under the Governments uniform pricing policy Horizon Power is required to charge it's household and small business customers the same price as exists in the SWIS despite the actual costs of providing the service being considerably higher. For example, in our recent inquiry into Horizon Power (the final report was released last week), the average tariff across Horizon Power's various towns ranged from $0.28 per kWh to $1.46 per kWh with an average overall of $0.38. This compares with the figure for the SWIS of $0.19 per kWh.

The subsidy to enable this currently comes from the Tariff Equalisation Contribution which is a charge levied on users of Western Power's distribution system. This is not an insignificant cost. For the current Access Arrangement (three years 2009-10 to 2011-12), the gazetted levels are $122.1m, 175.7m and $181.2m respectively which is increasing Western Power's distribution charges by CPI plus 15.7% in three instalments (March 2010, July 2010 and July 2011).

According to our Final Report there is a justifiable argument that the gazetted amounts for 2010-11 and 2011-12 should be lower (by approximately $36m and $25m respectively), however, they are still significant amounts. In the Report we have recommended that the TEC is removed and Horizon Power is funded directly by a CSO paid directly to Horizon Power. The benefits of this are:

- Lower distribution network tariffs in the SWIS;
- Removal of price distortion in the competitive markets in the SWIS;
- An earlier time frame to achieve cost reflective retail tariffs and therefore full retail contestability in the SWIS; and
- Greater transparency around the overall level of the subsidy for Horizon Power.

A policy decision by the State Government to accept this recommendation would be consistent with a market approach.

There are other areas where there are concerns that costs may not be appropriately

allocated or where there is a lack of competition and these are currently being considered (and hopefully addressed) through the various processes led by the Independent Market Operator (IMO). These include:

- The possibility of Western Power moving from an unconstrained to a constrained network which would hopefully lead to lower levels of network augmentation being required;
- The design framework for introducing competitors to Verve Energy in the provision of balancing and ancillary services, as long as it can be demonstrated that the benefits will exceed the costs;
- The proposed capacity valuation method for assigning capacity credits to wind generation that better reflect its contribution at times of peak demand (which the ERA believes has merit); and
- The review of the Reserve Capacity Mechanism of the market, including consideration of whether the mechanism is efficient in delivering the optimal mix of generation and demand side capacity.

Future Strategy

The ERA supports the IMO, on the advice of the Market Advisory Committee, taking the lead on specific projects that will improve the efficiency of the market. However, this process would be improved by refining the Market Objectives so that it is clear that economic efficiency is the priority. At present, the Market Objectives include a range of potentially inconsistent objectives. An overriding objective along the lines of the Electricity Access Code could provide greater clarity and ensure that the objective is the long term interests of consumers.

However, if we are at a crossroad, and there are significant challenges facing the WA electricity market (e.g. the lack of a policy direction, the cost pressures arising from renewable energy incentives and a future carbon price, the possible move to a constrained network etc), then these issues are too substantive to be left to the IMO alone. In my view, the Office of Energy needs to be appropriately resourced to take the lead on this work, which should be conducted in a transparent and consultative manner. Importantly, to the greatest extent possible, this work needs to be conducted at arm's-length from the State Government, given the conflict of interest the State Government has as owner of the three dominant players in the market, Verve Energy, Synergy and Western Power. (In the NEM, this work would be done by the independent AEMC.)

Conclusion

But maybe I am wrong, maybe we are not at a crossroad and there is no need to be concerned.

I remember the very active and vocal involvement of major players at the time the reform agenda was being promoted. Organisations like the CCI and the CME were

playing very active roles. The was even a special industry group established just to promote the reform agenda – the Independent Power Advisory Group, who had as its manifesto:

> *"IPAG will seek to uphold the competitive neutrality principle in both the supply (wholesale) side and demand (customer access, retail) side; advocate equitable and economic access to the public (transmission and distribution) infrastructure; propose transparent, fair and consistent market rules and regulations for all participants; argue for an alignment of WA's Technical Code with the National Electricity Market's Code; and support consumer sovereignty – customer choice."*

At least publically, I don't see a similar level of activity currently, and yet, at least in my view, the need is still there – we have no room for complacency – surely the regulator is not the only one who still believes that competitive, transparent markets will deliver the best outcomes for consumers!

There is one group that is very active, and while it will be obvious by now that I do not agree with everything they say, all credit must go to Ray Wills and the Sustainable Energy Association for the impact they are having on the debate. The SEA (and therefore presumably the members of the SEA) are supportive of, and have promoted, those government policies that I have been critical of such as the Feed-in tariffs and the Renewable Energy Target. This would be understandable if the members were all involved in the renewable energy business. And yet when I look at their list of corporate members I see organisations such as Alinta, Synergy, Western Power, Horizon Power and major consumers of electricity such as Rio Tinto, Wesfarmers, BGC, and BHPBilliton.

So, perhaps I am wrong and worrying unnecessarily. After all, my household personally consumes relatively small amounts of electricity (especially since my son left home). The ERA itself is a very small energy user. And from a Regulator's point of view, the farther we are from competitive markets, the more likely there is to be a need for greater regulation.

If nothing else I have said today is of concern to you, then that last comment on its own should be enough.

Thank You.