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Topic: Achieving a functional and efficient national energy market

I would like to thank Mark Birrell and Infrastructure Partnerships Australia for the kind invitation to speak at today's Conference.

Energy supply is of fundamental importance to every society and economy. It is technically complex, highly capital intensive, and long lasting. It's also, as this week's headlines show, a topic which is very much in the public eye.

Energy is a fascinating area of public policy because of the many choices it presents. With the emergence of climate change as a key public issue and rapidly rising energy prices (at least in part coincidently), these choices have been brought into the realm of public debate more than ever before.

In preparing for today's presentation I reflected on the history of the energy supply industry in Australia and as the choices that were made in its development.

This gives us a better understanding of the present and therefore better informs the choices we need to make for the future.

The guiding principle in the development of our domestic energy markets has been that a sustainable energy supply is best achieved through a competitive market, supported by effective regulation.

These choices have transformed a supply system which was based on state owned, fully vertically integrated monopolies into a sustainable supply system based on decentralised, commercially based decision making.

We should be proud of these achievements.

The National Electricity Market has delivered. It has met reliability standards. It has encouraged new investment. Wholesale prices (excluding carbon) are lower today than at market start. At the retail level we have numerous retailers competing for customers with some of the highest churn rates in the world.

But is the energy market fully efficient? Is it as productive as it could be? Have we reached the end of the reform journey?

I would contend that the answer to these questions is 'clearly not'.

We can see this reality in measures of productivity across the industry. Low productivity today is a result of low and inefficient capital utilisation across the energy industry.

We have an inefficient mix of plant which is poorly placed to respond to changes in energy demand. This inefficiency is contributing to the rising energy prices which make for daily headlines in the national press.

So what's gone wrong? What changes are we seeing in energy demand? And what are the responses to ensure a functional and more efficient national energy market?

EXTERNAL PRESSURES ON ENERGY MARKETS

There are certainly a lot of external pressures on energy markets. While Australian policy makers have tended to prefer efficient markets and effective regulation for the energy sector, there have also been a series of choices by other stakeholders that have affected how we supply and consume energy. Choices that have put the energy system under a lot of pressure.

As a society – governments, industry, consumers – we are asking more of the energy system than ever before.

We want our energy greener and we want to use more energy at peak times.

But then somehow we expect our energy to be cheaper.

Premium solar feed-in-tariffs have provided a sub-set of households with access to low-cost, renewable energy while making energy supply more expensive for every other consumer.

A price on carbon – a measure we support – also puts upward pressure on energy costs. However, fixed carbon prices at such globally high levels, together with restrictions on the use of low-cost abatement only adds unnecessarily to this cost.

It is absolutely clear that rising peak demand is driving up energy prices. It is also clear that time of use price signals are needed to address this. However, Governments, who claim to be worried about energy prices, continue to regulate prices to prevent these important price signals being passed through to consumers.

As a result, customers are not encouraged to adapt their consumption patterns and the industry needs to invest billions of dollars in plant and equipment which is used for less than 100 hours each year.

The energy market is resilient. It has survived a drought. It has survived the failure of a few retailers. It has survived incredible carbon policy uncertainty.

It has survived the uneasy mix of public and private ownership in the competitive sector that continues to this day. And it has so far managed to survive the misalignment between good energy policy and good energy politics.

However, over the past 3 years the pursuit of broader political objectives has started to impact the policy stability of the energy sector and has put the energy market under incredible pressure.

DEMAND FOR ENERGY IS CHANGING

Since the 1980s there has been a decline in the relative contribution to GDP from goods-producing industries, such as manufacturing, and a rise in the contribution from service industries.

More recently, the mining sector has grown as developing countries like China and India are using more and more of Australia's abundant mineral resources.

This change in Australian industry has significant implications for energy use.

- First, service related industries are less energy intensive and therefore we have seen a decline in Australia's overall energy intensity even though energy production has increased.
- Second, there is a change in the composition and location for industry demand.

Household demand for grid connected energy has also declined in recent years and the relationship customers have with their retailer is also fundamentally changing.

Consumers are seeking a deeper relationship, they want advice and support on how they can better manage energy in their homes.

New technology, such as smart meters and software to let customers take full advantage of them, will give customers a greater capacity to manage their demand.

Innovative products and tariffs will emerge on the back of that technology. This includes tariffs that empower consumers to better manage their energy usage, lower their carbon emissions and reduce their bills.

We are already seeing the introduction of products such as solar PV and solar hot-water for consumers to install in their homes as a means of managing their energy use from the network.

However, regulation will be a key barrier to these important changes.

Historically, Australia's energy sector has been a source of considerable prosperity for all Australians by providing access to low cost energy for businesses and households.

It is imperative that the sector continues to meet the future economic, social and environmental challenges of the country.

If it performs poorly, the international competitiveness of major Australian industries is undermined, our economy suffers and our standard of living will decline.

Therefore, any discussion on the requirements and pathways for a functional and efficient national energy market should begin with an assessment of how we transform energy supply to meet these structural challenges and changes in consumer demand.

WHAT ARE THE PATHWAYS TO A WELL FUNCTIONING AND EFFICIENT NATIONAL ENERGY MARKET?

Energy reform is a partnership. It takes a lot of stamina in a reform journey where governments, industry and consumers all need to work together.

I would like to talk about two key areas where government and industry must work together to achieve sustainable low cost energy supply for consumers – retail price deregulation and the renewable energy target.

RETAIL PRICE REGULATION

First, retail price regulation. The motivation behind the introduction of the NEM (and other competition reforms) was a desire to raise the efficiency and productivity of electricity supply in eastern Australia by taking advantage of potential cost savings from the interconnected state networks.

In essence, the NEM should have boosted productivity levels by allowing more efficient use of generation and network capacity.

While we have seen wholesale electricity prices decline in real terms, there have been other factors in recent years that have out-weighed the gains from the NEM structure.

A major contributor to poor productivity performance in the sector has been the need for considerable investment in peaking generators and networks to match peak demand for a small number of days each year.

Ultimately, low productivity means low capital utilisation and higher energy prices.

Unfortunately as energy prices have gone up we have seen increased community pressure on governments to respond.

This has made retail prices a major political issue with the natural reaction of most politicians to date being to seek to artificially manipulate the market for short-term political gain. Unfortunately the market just can’t deliver on that populist electoral promise of lower electricity prices.

When Governments owned and operated the power system, they could get away with setting retail prices below actual costs and/or cross subsiding a particular class of users to satisfy social and community expectations. Ultimately it was all taxpayers' money.

This is not the case today.

Victoria remains the only state which has introduced retail price deregulation.

As a result, Victoria is reaping the rewards of a highly competitive retail market where standing offers are a substantially smaller part of the overall retail market and households have the choice of over a dozen retailers competing for their business.

Competition has broadened beyond price and includes a variety of innovative product and service offerings.

In fact, the St Vincent de Paul Society has observed that the deregulated, competitive retail market in Victoria does more for low income households than retail price regulation in states like New South Wales and Queensland.

An example: The variety of offers available in the market means that households with high energy use can choose retailers who offer products with higher fixed costs and lower variable costs while those households with lower energy use can choose a different retailer with the opposite product offering.

These same households can then access a discount on these rates and a further discount if they pay on time.

Retail price regulation is a one size fits all approach and the discounts available in the competitive market are linked to this inflexible regulated product. This does not benefit many low income households.

Retail price regulation and the introduction of flexible (or what is often referred to as time-of-use) pricing structures is also critical if we are to help customers to manage their energy use throughout the day and get the most from their energy expenditure.

Time-of-use pricing is also imperative if we are to begin to tackle peak demand and improve the productivity and cost structure of the energy industry.

Today, retail price deregulation is the single most important reform that is required for Australia's energy markets if we are to deliver tomorrow's opportunities.

RENEWABLE ENERGY TARGET

What about the renewable energy target? One policy area where we have the opportunity to stop and reflect on our objectives and the impact of their delivery is the Renewable Energy Target.

There is a lot to like about the RET. It is one of the few current policy settings that has bipartisan political support and it has successfully encouraged new renewable generation investment. It uses a market price signal that encourages least cost deployment.

However, a key question currently facing the Climate Change Authority in its review of the Renewable Energy Target is how to define the 20% target. Rather than rush out and take a position, we commissioned some analysis from ACIL Tasman.

This modelling found that, unchanged, the current 20% renewable energy target will actually deliver over 25% renewable energy at a cost of nearly $54 billion from here to 2030.

In the context of falling demand, this target could be recalibrated to deliver the original policy intent of 20% renewable energy while reducing the overall cost of the subsidy by $25 billion.

$25 billion across the economy is a big saving to consumers – $840 each – in the context of rising energy prices.

The current design of the renewable energy target also puts incredible pressure on the wholesale electricity market.

A policy that forces new capacity to be built in an already oversupplied market, with falling demand, calls into question the sustainability of the market itself.

While policy stability is very important, we need to balance this with a scheme design that can adjust to fluctuations in demand and not impose unnecessary costs on the economy and our customers.

CONCLUSION

In conclusion, Australia has shown it has the capability to build a sustainable, world class energy system that underpins economic, social and environmental performance.

Building on the existing energy supply infrastructure, we can work towards lower carbon emission levels and maintain high levels of supply reliability.

We can introduce smart grid technology and we can deliver power more efficiently to customers, giving them more information and greater choice about the way they use energy.

The opportunity, but also the obligation for Australian governments, is to maintain the reform agenda towards achieving a well functioning, competitive and efficient national energy market.

This market works, but be careful we don't ask too much of it, as it could begin to break-down.

Australia's energy markets have served us well. We should protect them and develop them.

We need to get out of regulating prices and get on top of peak demand to ensure the sustainability of the energy sector.

We need to tidy up the raft of climate change schemes – including the Renewable Energy Target – and move to a least-cost approach to emissions reduction and renewable deployment at sustainable levels.

We need to support gas development and gas markets to the benefit of industry, consumers and the community.

But most importantly, we need to get the politics out of energy supply.

Thank you.