

# “Energy Markets – What Will They Look Like in 10 Years Time?”

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Lyndon Rowe  
Chairman

## **INTRODUCTION**

Thank you to the organisers – the Office of Energy and the Australian Institute of Energy – for the opportunity to make some comments at this important conference.

I should also say, thank you to the Minister for Energy for his comments yesterday, which meant that I had to go home last night and rewrite some of what I was proposing to say. Minister Collier's announcement that Verve and Synergy will remain separate is very welcome and very important to the future development of the energy market in WA.

I only have fifteen minutes and so will focus on high level issues rather than issues of detail and given that no one knows what the energy market will look like in ten years time I will ask an easier question – What should the energy market look like in ten years time and why? Having shared my vision of where we need to get to, I will then spend some time looking at whether we are on the right track to get there.

I should also start by issuing the usual disclaimer – the views I express are mine and not necessarily the views of the Economic Regulation Authority.

### **Current Situation**

The energy sector in WA is currently in transition from a publically owned, vertically integrated monopoly (in the past supplying both electricity and gas) where decisions were made administratively to an energy market (albeit with various degrees of regulation) where commercial decisions, ideally based on cost reflective prices, drive outcomes. While the market is still developing, we have seen increased competition in electricity generation and for larger users increased competition in retailing of both gas and electricity.

It is important that we continue to move towards a competitive energy market. The Minister's announcement will help.

### **What Should the Market Look Like in 10 Years Time?**

In my view, the evidence is overwhelming that markets characterised by effective competition are more likely to result in an efficient use of resources and be responsive to the needs of consumers than a more centrally controlled, managed market where the interests of consumers will often rank second to political and/or producer interests. I would be happy to debate this but I don't have the time and so I am going to take this as a given – as I say, I think the evidence is overwhelming.

Therefore, in ten years time, the energy market should have the following characteristics:

- Competitive and innovative wholesale and retail electricity markets where no one generator has more than 30 per cent of the market and no one retailer has more than 40 per cent of the market. Ideally, the shares of the market of the dominant generator or retailer would be less but I am conscious of the starting point and also the small and isolated nature of the Western Australian market. The wholesale market would continue to be run by the Independent Market Operator (IMO) to ensure transparency for participants. Retail tariffs for small use customers would no longer need to be regulated due to the competition and retailers would be competing not just on price but by offering energy solutions.

- (In ten years time we should have) a competitive and innovative wholesale gas market, again run by an independent market operator to ensure transparency (may or may not be the IMO). The higher gas prices of recent years have fulfilled their role in encouraging exploration for, and development of, new gas fields and there are now several gas producers competing for customers and gas prices (in real terms) are below current levels. There are also a number of gas retailers competing, not just on price but offering energy solutions.
- (In ten years time) Adam Smith's "invisible hand" should be at work ensuring efficient outcomes responsive to the needs of consumers as market participants make commercial decisions based on cost reflective prices. The market rules and the transparency of the market have ensured that all costs are appropriately allocated to those responsible for causing those costs to be incurred – an efficient outcome requires a "user pays" approach including cost reflective retail prices to encourage the efficient use of energy.
- (In ten years time there should be) a minimal role for Government. It may still be the case that through the market rules the Government will set the security requirement for generation capacity (based on advice provided by the IMO on the costs associated with various levels of security). The Government may also still be the owner of the distribution and transmission network but with independent regulation (by the ERA) to ensure transparency – unless technology has changed, so that this sector of the energy market is no longer a natural monopoly, in which case there may no longer be a need for regulation. In order to avoid conflicts of interest (and to encourage greater efficiencies), Synergy and Verve have both been privatised.
- (In ten years time there should be) no role for the Government to interfere in commercial decisions – long gone are decisions about the next power station being made on the basis of whether or not they will be located in marginal electorates! (As is already the case because of the transparency provided by the role of the IMO.) Similarly, in my view, there should be no attempt to use energy as part of an industry development policy. Although, if the Government does decide to do that, it is likely to be through the network and because of independent regulation the process will be transparent and will have to be funded by taxpayers rather than through cross subsidies from other energy users. Consistent with a desire to remove cross subsidies, the subsidy for Horizon Power to support the uniform pricing policy will be funded by taxpayers through CSO's rather than by users of the distribution network as is currently the case.

### **What are the advantages of a genuine energy market?**

The advantage of the impersonal, competitive market where no participant has significant market power is that it is more likely to deliver positive outcomes for consumers than a more managed market where there is the potential for all sorts of vested interests to be at work.

There are at least three reasons for this:

- First, the former is much more likely to be transparent with all participants having access to the same information on a level playing field – a situation far more likely to encourage new participants into the market place.
- Second, there is likely to be a much more efficient use of limited energy resources if decisions in the energy sector are made on good commercial grounds than if they are made on political grounds.
- Third, and in my view most important, "more players in the market" is likely to lead to more innovation in responding to meet the needs of consumers. There are a number

of prerequisites that are needed in a market place to encourage participants to invest time and money in exploring new ways of responding to consumer demand. Those prerequisites include transparency, independent market operators and regulators, political certainty and legal certainty. A competitive energy market is more likely to meet these criteria than an administered energy market.

This issue of innovation is extremely important. The energy sector faces a number of challenges and uncertainties in the next ten years from fluctuating energy prices and supplies to dealing with climate change policies such as the pricing of carbon. The market will need to be flexible and innovative in responding to those challenges if we are to provide Western Australians with the lifestyle they have come to expect.

We don't know what we don't know! We have already seen the advantages that have come from opening up the electricity generation market to new players. I don't think anyone would argue with me when I say we have seen generation solutions emerge that would not have emerged under the former vertically integrated Western Power. We need to encourage as many participants as possible to be thinking about the options that could be on the table to ensure that we respond to challenges in the energy market in the most efficient way.

(Incidentally, the ERA believes this argument is equally valid in the water industry with new bulk water proposals being analogous to generation. In a Report to the Government in the middle of last year we proposed the establishment of an Independent Procurement Entity.)

### **Are We On The Right Track?**

Given the announcement by Minister Collier yesterday, I can be more positive than I thought I might be. Keeping Synergy and Verve separate will help to keep competitive tensions in the market place whereas a merger would have been a significant deterrent to new entrants.

Similarly, the steps the Government has taken to ensure cost reflective tariffs is to be welcomed. Consistent with that objective, I would encourage the Government to consider making independently regulated changes to network tariffs an automatic flow through to regulated retail tariffs.

The proposed CPRS and the recently passed Renewable Energy targets are less encouraging as they seem to be leading to an administered rather than a market outcome.

A CPRS puts a price on emissions of CO<sub>2</sub> and other greenhouse gases. This aims to ensure that investment and operating decisions take account of the negative externality associated with such emissions. Properly designed, this should help promote efficient outcomes. However, anyone watching the process would have to be concerned at the political lobbying that is going on as part of that process. It seems to be a reasonable question to ask – who is looking after the consumer's interest?

A mandatory renewable energy target is of greater concern. In contrast to a well designed CPRS, an MRET deliberately favours certain generation plant technologies over others. In the absence of a CPRS, this may be a second best option for reducing greenhouse gasses. However, with the commencement of a CPRS, an MRET is more likely to promote investment in renewable plant (particularly wind in WA) that is not justified by the prevailing cost of carbon and hence is inefficient.

There are a number of dangers in any Government seeking to artificially encourage industries. In some ways, this is analogous to the inward looking protected industry structure Australia had in the past when industries spent as much time lobbying government to further their commercial interests as they did in looking at ways to respond to consumer demand. Simplistic arguments about the amount of investment that might be created are simply repeating the discredited arguments put forward by proponents of industry protection in the past.

There is a final issue that has the potential to be either a positive or a negative. At this same conference last year and again this year there has been a lot of talk about the need for the Government to have an energy policy. Can I just say, be careful what you ask for, you might just get it!

The problem is that while everyone wants an energy policy, everyone has a different idea about what should be in it. Although I wasn't here yesterday, I understand this might have been illustrated by a question Garry Jeffrey asked Alan Cransberg from Alcoa yesterday.

In my view, if the Government was to have an industry policy which has as its objective to remove impediments or obstacles that might be 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 and hence the Western Australian community more generally.

Given the need of Governments to be seen to be doing something in response to calls for action from the public, I would again sound a note of warning to be careful of what you ask for.

## **CONCLUSION**

In ten years time I hope we will have a well functioning competitive market. The electricity reforms in WA have been worthwhile and the market, while still developing, is delivering better outcomes for consumers. There are changes needed, which is not a surprise as the system was always to evolve over time, but in thinking about those changes the overriding objective should be one of economic efficiency – this will be in the long run interests of consumers.

Any further reforms should seek to exploit opportunities to create competitive tensions in the market place. I hope you will all accept the Minister's invitation yesterday to contribute to the reform process and that in doing so, the basis on which you will judge any proposed reforms is the extent to which they will aid in achieving the competitive market I have outlined.

Of course for those of you who disagree with me and believe there is a need for a much more interventionist role by Government, I need to declare an interest as it would not be all bad for me. Under your preferred approach there will be a much greater role for regulators!!! – that alone should help change your mind.

Thank you.

Lyndon Rowe  
Chairman  
Economic Regulation Authority