

Energy Regulation and Its Role in WA

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Introduction:

Thank you for the opportunity to again present to this important Conference.

The topic looks like something I might have addressed in 2004 when the ERA was first established. However, it is very timely as it appears there is a lot of confusion about the role of the independent regulator in the energy sector.

Energy is also the subject of a lot of debate. If we are to make good decisions that promote the long term interests of Western Australians then we need clarity and transparency in that debate. I want to suggest a way forward that keeps the focus on the needs of consumers.

I have an underlying text for today – it comes from the late Frank Devine:

“Politics is for the sceptical consideration of wise men and the eager embrace of rent seekers.”

Its relevance, if not already clear, will hopefully become so.

The ERA does not set or recommend retail or wholesale prices for electricity or gas:

Let's first look at some of the recent misrepresentations about the role of the ERA. I'll use two examples.

On August 3 on the WAToday website regarding the release by Verve of its profit results for the year to March the following appeared:

“Electricity prices rose again on July 1.....The most recent 5 per cent increase was much lower than the 22 per cent recommended by the Economic Regulation Authority.....”

I have no idea where that 22 per cent came from. The ERA has not made any recommendations to the State Government about retail electricity prices.

However, I note, two issues associated with Verve's report.

First, Verve reported a significant increase in profits, in part due to favourable pricing. It would be interesting to know to what extent this is driven by the replacement vesting contract and how that impacts on Synergy's costs. The ERA has just released an Issues Paper for our current inquiry into the efficiency of Synergy which requires us to examine the efficiency of Synergy's operations including the efficiency with which Synergy contracts for generation

capacity and meets its renewable energy obligations and so the impact of the replacement vesting contract will be considered.

Second, Verve report that the “forced outage factor was down on last year reflecting the improved reliability of Verve Energy’s plant”. However, Verve also indicated that overall plant availability is down from the previous year (77.4% this year compared to 85.1% the previous year). It would be interesting to contrast Verve’s experience with planned and forced outages and the impact of both on the market, including the impact on STEM and balancing prices. The ERA will consider this issue in more detail.

The second example also comes from the WAToday website. On July 20, it had an article regarding the increase in retail gas prices. The article reported the Premier as supposedly saying:

“He said it highlighted inherent problems in the gas supply industry, questioning the Economic Regulation Authority’s decision in April to allow gas suppliers Apache Santos and the North-West Shelf joint venture partners to charge 29 per cent more to wholesale buyers such as Alinta”

It is highly unlikely that the Premier did say any such thing. The ERA has no role in the setting of wholesale prices for gas and has not made such a decision – it would certainly be news to the two gas producers mentioned and for Alinta (although given recent history, Alinta might have been happy with just a 29 per cent increase in gas prices!). The decision in April related to the Access Arrangement for the South West Gas Distribution System.

What is the Role of the ERA in the Energy Market?

Let me start by looking at our role in the gas industry.

The ERA’s Licensing, Monitoring and Customer Protection Division has an ongoing role in licensing gas distributors and retailers, monitoring their performance and overseeing some customer protection provisions.

The ERA’s Access Division sets the terms and conditions for access to monopoly providers of transmission and distribution gas pipelines – in particular, the Goldfields Gas Pipeline, the Dampier to Bunbury Natural Gas Pipeline and the Mid West and South West Gas Distribution System. The ERA’s decisions are independent decisions not recommendations to government but they are subject to appeal on legal matters to the Supreme Court and to merit reviews by the Australian Competition Tribunal (ACT).

In the case of the Goldfields Gas Pipeline, the ERA released its Final Decision on 5 August last year. That decision is subject to two merits appeals before the WA Electricity Review Board (not the ACT as the Access Arrangement was lodged under the old Gas Code) with the major matters under review being the allowable rate of return and whether pipeline expansions should be covered by the Access Arrangement.

In the case of the Dampier to Bunbury Natural Gas Pipeline, the ERA released its Revised Access Arrangements Draft Decision on 14 March this year, there was an extended period of public consultation and the ERA is now considering those submissions as it prepares its Final Decision.

Given the confusion around the ERA's role in retail gas prices and some public criticism by the Premier with respect to the ERA's decision on the Gas Distribution System I want to focus a little more on this decision. The confusion has continued as I note the Premier in response to a question in Parliament last week said:

“Yes, there is a 10 per cent increase in gas prices. The Economic Regulation Authority had recommended increases close to 30 per cent.”

We do not have a role in either setting or recommending retail gas prices. It is my understanding that the 30 per cent recommendation was made by the Office of Energy. (As discussed later there may have been some confusion with the 29 per cent increase in distribution network charges which if fully passed through would have led to a 7 per cent increase in retail prices.)

With respect to the Premier's criticism of the ERA decision, the Australian on July 21 reported:

“...he (Mr Barnett) attacked the Economic Regulation Authority for its “quite extraordinary” decision to grant the 29 per cent rise in the cost Alinta paid to use the network. ‘I just struggle to see how you could justify it for using pipelines which are already in existence,’ the Premier said.”

Further, the following day, the Courier Mail reports:

“Mr Barnett said he would be reviewing the system of regulation surrounding the energy sector.”

The ERA released its Final Decision on February 28 this year with the new network tariffs taking effect on July 1. The decision is subject to a merits review by the ACT with ATCO Australia (formerly WA Gas Networks), the owner of the distribution system, and Alinta making applications to appeal. In the owner's case the most significant issue of concern is the allowable rate of return and Alinta is appealing the step change in tariffs arguing that the increase should have been phased in. If the ATCO Australia appeal is successful then network charges will increase further.

It is not my intention to debate the merits of the ERA decision but to outline some facts with regard to the decision to help clarify some of the confusion that seems to be about.

The ERA reduced the original revenue claim (over the 4 ½ years) by \$77m to \$548m (real December 2009) largely as a result of reducing the rate of return proposed. The ERA's analysis showed that if our approved network charges were fully passed through to retail prices the average residential user would incur an increase of 7 per cent nominal – a cost of

around \$0.67 per week. The network charge increases that came into effect on July 1 this year were the first increases since January 2009 and under the approved Revised Access Arrangement the increases on July 1, 2012 and July 1, 2013 will be limited to CPI increases only (the current Access Arrangement expires on June 30, 2014).

With respect to the Premier's comments regarding costs of existing pipelines, the increase network charges were driven by a number of factors including a decrease in average consumption (and therefore a need to increase the cost per unit consumed), increases in network assets and operating costs and an increase in the rate of return.

A 'step change' tariff option (i.e. initial increase followed by tariffs remaining constant in real terms) was chosen by the ERA as it resulted in tariffs being 9 per cent lower in 2013/14 compared to a 'smooth transition' and at the same time reduced the revenue to be collected over the regulatory period by \$2m (real December 2009).

So, yes the ERA sets network charges for the distribution system and on average, for residential consumers, there was a one-off 29 percent increase on July 1 this year. No, the ERA does not set or recommend retail gas prices, however, on our calculations, if the increase in network tariffs was to fully flow through into retail prices, the average impact would be around seven per cent nominal.

With respect to the Premier's criticisms of economic regulation, the ERA agrees there are changes that could be made to improve the current rules and regulations. In particular, the ERA believes there are aspects of the "propose/respond" model that could be improved and we are concerned about providers' ability to "cherry pick" particular aspects of regulatory decisions as the basis for a merits review – this has tended to make appeals by infrastructure owners a "one-way bet".

Let me now turn to the ERA's role in electricity.

The ERA's Licensing, Monitoring and Customer Protection Division has an ongoing role in licensing electricity generators, transmitters, distributors and retailers, monitoring their performance and overseeing some customer protection provisions.

The ERA's Economics Division undertakes independent inquiries at the request of the State Treasurer.

Earlier this year the Treasurer released our Final Report into Horizon Power. The Government has yet to announce its response. Coming out of that Report were two issues of relevance to the overall electricity market.

First, the ERA recommended that the current Tariff Equalisation Contribution (\$181m in 2011-12) that is levied on users of Western Power's distribution network should be abolished and the subsidy to Horizon Power to enable small business and residential customers to pay the same tariffs as customers in the SWIS should be met by a Community Service Obligation (CSO) payment. The effect would be to lower distribution network tariffs, remove a price

distortion in the market and allow an earlier time frame for cost reflective retail tariffs and full retail contestability.

Second, the Report found that the size of the TEC required by Horizon Power should be less than currently gazetted by the State Government. If the TEC is to continue this will be a significant consideration in the forthcoming assessment of Western Power's next Access Arrangement.

In May the ERA released its draft report into the State's Underground Power Program. You probably saw the headline in the West Australian – "Price of buried power may soar". The headline could have just as easily said "Electricity consumers and taxpayers subsidising Perth's expensive home owners". I don't have time to go into the detail however it is worth noting that with better targeting the Report suggests that for the same outlay, the State Government could achieve higher levels of underground power.

As mentioned earlier the ERA has just released an Issues Paper for our current inquiry into the efficiency of Synergy.

In undertaking these independent inquiries, the ERA is not a decision maker but rather makes recommendations to the State Government. The Reports must be made public.

The ERA's Access Division sets the terms and conditions for access to Western Power's monopoly provision of its transmission and distribution network. The current arrangement (AA2) expires on June 30, 2012. Western Power is required to submit their third Access Arrangement proposal at the beginning of October this year. I note that in the March quarterly report, Western Power reported earnings before tax for the year to date of \$188.5m which was \$103.3m more than the target. The reasons for this will be part of the ERA's considerations when assessing Western Power's Access Arrangement proposal

Finally, the ERA's Economics Division has a role in monitoring the performance of the Wholesale Electricity Market including providing an annual report to the Minister for Energy. Our most recent Report was tabled by the Minister in Parliament last week.

Very briefly, the Report concludes that the Market has been relatively successful, however, the Report highlights that the Market is still dominated by Verve Energy and Synergy. A number of issues which concern the ERA include:

- Market competition, particularly the slow progress towards increased competition in the retail market and the need for clarity about the State Government's policy intentions and timeframe for increasing competition;
- The ongoing need for market power mitigation;
- Whether the Replacement Vesting Contract encourages the development of competition in the market;
- The inefficiencies of some renewable energy schemes and their adverse impact on consumers;

- How do we ensure that the market continues to evolve in the long term interests of consumers?

I want to comment in a little more detail on this last issue – how do we ensure the market delivers efficient outcomes – but first a quick reminder of what is the long term objective of energy market reform. This is necessary because there is a risk that in undertaking individual reforms we do not always focus on ensuring the individual reforms are consistent with the overall objective of a well functioning energy market.

What is the Objective of Reform?

The underlying assumption behind the reform agenda was that transparent competitive markets provide the best outcome for electricity consumers.

If the Government was to have an energy 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.

Often it is political or producer interests that take precedence over consumer interests.

An example in the energy market is the response to renewable energy. Anyone who watched the debate around the legislation that introduced the Renewable Energy Target would have seen plenty of examples of political interests or the vested interests of renewable energy providers but would be forgiven for thinking that consumer cost-of-living interests were not at the forefront of that debate.

At a State level the introduction of the Feed-in tariff for domestic PV systems had a lot to do with the political need to be seen to be encouraging renewable energy than it did about the long term impact on electricity prices to consumers. The ERA's Report deals with this and a recent Productivity Commission report also concluded that this is not an efficient way to reduce carbon emissions.

It is often the case that attempts to interfere in the market are done more in response to vested interests (political or producer) rather than the interests of consumers. The benefits of intervention are often highly concentrated among a relatively small, but vocal group who have much to gain by lobbying the Government to intervene in the market place while the costs, which in aggregate are more often than not greater, are more widely dispersed over the population at large who do not have the same incentive to lobby as hard.

Another example of vested interests receiving more consideration than consumer interests is in the policies based around the Federal Government's "Clean Energy Future" proposals. I am sure no one could deny that political interests played a large part in the final package of initiatives.

The ERA has argued in its recent report to the Minister that a price on carbon is likely to be a more efficient way of achieving reduced carbon emissions than interfering in the market by favouring one form of energy over another. In fact, if you have a price on carbon which deals with the external costs of carbon emissions, then there is no case for targets or subsidies.

The Federal Government's own document "Securing a Clean Energy Future" gets the words right at least in one part when it says:

"Rather than relying on government decisions to regulate some activities or subsidise others, a carbon price leaves it to millions of businesses and consumers to find the most cost-effective ways of reducing carbon pollution. Analysis of more than 1,000 different policies to reduce emissions by the Productivity Commission shows that market-based approaches like this are the most cost-effective way of reducing carbon pollution."

Unfortunately the policy does not live up to this good starting point and so in addition to a carbon price we have a large range of programs, initiatives and special funding – all ripe for special interest pleading! For example, proposed are:

- Clean Energy Finance Corporation
- Australian Renewable Energy Agency
- Clean Technology Program
- Clean Energy Skills Program
- Clean Technology Focus for Supply Chains Programs
- Low Carbon Communities
- Remote Indigenous Energy Program
- Energy Savings Initiative
- Energy Efficiency Opportunities Program
- Carbon Farming Initiative non-Kyoto Carbon Fund
- Carbon farming Futures Fund
- Biodiversity Fund
- Regional NRM Planning and Climate Change Fund
- Indigenous Carbon Farming Fund
- Carbon Farming Skills Initiative
- The Independent Land Sector Carbon and Biodiversity Board
- And, of course, the renewable energy target continues.

Almost everyone but the poor consumer seems to be catered for!! Frank Devine was right!

How Best to Progress the Reform Agenda

I want to conclude by making some suggestions about how ongoing reforms can be delivered in a way that has the best chance to promote the interests of consumers rather than "rent seekers".

While the ERA supports the work streams currently underway under the Independent Market Operator (IMO), we also noted in our recently released Minister's report that:

"....the challenges facing the market....are too substantive to be left to the IMO alone. The Office of Energy should be funded to take the lead on this work, which should be conducted in a transparent and consultative manner. Importantly, this work needs to be conducted, to the extent possible, at arm's-length from the State Government, given the conflict of interest the State Government has as owner of the two dominant players in the market, Verve Energy and Synergy."

In the ERA's view the Office of Energy has not been adequately focussed and/or resourced at the level required to undertake this work. However, in the absence of a State equivalent of the Australian Energy Market Commission (and given the size of the WA market we don't think it would be cost effective to create such a State body) it is the Office of Energy that is best placed to ensure that as the market evolves we continue to focus on the best outcome for consumers. It does not have the vested interests of other participants in the market, including to some extent, the IMO. However, a challenge will be to keep political interests to a minimum.

We need an open, transparent and very consultative process. An open forum led by an "independent" Office of Energy where all participants can express their views and have those views tested is, in the ERA's view, more likely to:

- ensure that the focus remains on the long term interests of consumers;
- ensure we give priority to those issues most likely to deliver benefits to consumers;
and
- ensure that the benefits of future reforms exceed the costs.

The model we have in mind is the process that was adopted by the then Office of Energy's Electricity Reform Implementation Unit.

The work requires a high level of expertise, the agenda is growing and the "rent seekers" need to be kept at bay – a properly focussed and resourced Office of Energy should be a priority for the State Government.

Thank you for listening.