Business Council of Australia

BUSINESS COUNCIL OF AUSTRALIA

SUBMISSION TO THE ENERGY REFORM IMPLEMENTATION GROUP

SEPTEMBER 2006

TABLE OF CONTENTS

1 INTRODUCTION

The Business Council of Australia (BCA) welcomes the establishment of the Energy Reform Implementation Group (ERIG) to report to COAG before the end of 2006 with detailed implementation arrangements to:

1. Achieve a fully national transmission grid including the most suitable governance and transitional arrangements giving consideration to matters such as the "legitimate" commercial interests of asset owners and the need to promote investment.
2. Address structural issues impeding competitiveness and efficiency.
3. Ensure there are transparent and effective financial markets to support energy markets.

The work of ERIG is timely as the BCA considers there is an urgent need for Australia to re-establish forward-looking and coherent strategic directions for national energy market development.

This submission is made by the BCA, an organisation representing the Chief Executive Officers of Australia's leading 100 companies. Collectively, these companies employ around one million people and are responsible for a significant share of Australia's interaction in global markets through trade and investment flows.

This submission supplements the discussions held between Members of the BCA Sustainable Growth Task Force and members of the ERIG panel on 24 August 2006.

A key focus of the BCA's work is developing and advocating a policy reform agenda aimed at locking in Australia's economic prosperity. The BCA's policy agenda focuses strongly on building the foundations for sustained economic growth as the basis for achieving prosperity more broadly defined. Business clearly has a vested interest in such reform – strong economic growth is obviously good for business. But a vibrant, competitive and profitable business sector is also good for Australia, delivering jobs and income growth, higher tax revenues and better investment returns for shareholders and superannuation funds.

The BCA policy reform agenda has been developed on the basis of independent research and highlights the need for reform in four key areas of the economy to lock-in current levels of prosperity for the long-term. They are workplace relations, taxation, regulation and infrastructure renewal.

Specifically, the BCA assessed the current state of a selection of Australia's economic infrastructure sectors, including energy related infrastructure, with the release of its *Infrastructure Action Plan* in March 2005. It found that as a result of poor institutional arrangements and policy choices, Australia's infrastructure is in urgent need of expansion, reform and repair. It found serious bottlenecks in key areas of the economy that, unless addressed, would pose major constraints on future growth. In particular the *Action Plan* noted that energy demand will exceed current supply levels by 50 per cent by 2020.

The *Infrastructure Action Plan* concluded that the development of quality infrastructure is essential to alleviate capacity constraints within the economy and ensure Australia's continued international competitiveness. However, the *Action Plan* noted that funding was not the primary issue. Rather, the major barrier to better infrastructure to support future growth has been a lack of proper strategic policy and planning by and between Governments. The *Action Plan* stated that a sustainable system of infrastructure cannot be achieved without structural and systematic change in the governance and planning of infrastructure policy in Australia particularly given our federal system of Government. To achieve a sustainable basis for Australia's economic infrastructure, the *Infrastructure Action Plan* called on COAG to lead a national and integrated infrastructure reform program.

In examining energy infrastructure constraints the BCA noted:

- the negative impact of retail price caps;
- limitations to the effective operation of and investment in the developing national electricity market through different ownership models;
- limitations on market operation and transmission investment decisions as a result of the current regional market structure;
- the negative impact of the regulation test on new transmission investment;
- poorly developed regulatory frameworks for distribution which do not support service standards;
- greenhouse policies which differ across States, favour different technologies and create investment uncertainty; and
- poor price signals to inform consumer behaviour.

The decisions made by COAG in February 2006 with regard to energy provide the basis for moving forward and addressing key aspects of these constraints. The table below (reproduced from the 2006 BCA publication *Benchmarking the Progress of Infrastructure Reform)* highlights the key agreements of COAG and the matters to be addressed through ERIG.

COAG AGREEMENTS ON ENERGY

KEY DECISIONS	**ELABORATION**
+ Phase out retail price caps where effective competition can be shown.	+ Reviews to establish this will commence in 2007. The details of decision-making process are to be determined.
+ Progress rollout of electricity ‘smart’ meters from 2007.	+ Implementation must consider States’ individual circumstances and cost-benefit.
+ Australian Energy Regulator (AER) to regulate all transmission and distribution for electricity and gas.	+ An expert group is considering new pricing principles to guide this regulation in the future.
+ Strengthen national transmission: - improve framework for planning and investment; and - consider establishing a national grid.	+ A high-level COAG Energy Reform Implementation Group has been established to develop detailed implementation arrangements. This gives these issues profile, but the nature and extent of future change is unclear.
+ Consider measures to address structural issues, including: - separate generation/transmission; and - ownership and structure of GBEs.	
+ Consider measures to ensure effective financial markets.	

The work of ERIG is critical to ensuring we have the required energy infrastructure to sustain economic growth.

Prior to addressing the terms of reference of ERIG it is important to note the benefits from previous reforms in energy and the reason why such reform must continue.

2 The Benefits of Past Reform

The programme of economic reform – of which energy reform is a significant component – has underpinned the transformation of Australia’s economy during the 1990s and helped Australia avoid the setbacks experienced by other overseas countries.

If Australia is to simply maintain its current position within the OECD it will need to grow, on average, by at least percent per annum in the years to come. This growth will result in similar growth in the energy sector requiring significant investment in energy infrastructure.

Changes to the National Electricity and Gas Markets over the past fifteen years have brought about improvements such as enhanced efficiency and productivity in energy supply and some customer and industry segments have also achieved benefits such as price reductions and improved supply reliability. However the reform process is incomplete and not all customer and industry segments have realised the benefits of energy reform.

An efficient energy sector is vital for all economies, but particularly for Australia. Electricity and gas are critical inputs to all businesses and consumers in Australia. The relative low cost of Australia's supplies of energy resources has also encouraged the growth of a number of energy-intensive industries including aluminium smelting, non-ferrous metals, chemicals, paper and steel manufacturing where electricity and gas costs are a major input cost (from 15 to 30 percent).

Further energy reform is essential to ensure our current competitive advantages are not eroded through inaction – delays in progress towards a more efficient national electricity market could put at risk the newly found strength of our domestic industries and economy.

3 POLICY OUTCOMES AND STEPS FOR ENERGY REFORM

The BCA has previously highlighted the desired policy outcomes from reform of the electricity and gas sectors. These are:

- sustainable and effective market mechanisms;
- competitive neutrality;
- Government policies that do not influence investment in and the operation of the energy market adversely;
- transparent and accountable regulatory institutions;
- efficient and consistent regulation where regulation is required; and
- improved electricity interconnection.

Steps to achieve these outcomes for electricity include:

- the structural separation of vertically integrated entities into competitive (generation and retail) and monopoly network components;

- access to monopoly networks with the terms and conditions of open access established under a system of informed national economic regulation; and
- the creation of a national market (ie East and South Australia) linked by strong interconnectors, and with many producers and sellers able to compete in the market place.

Whilst for gas the steps include:

- competition amongst producers within and between gas basins;
- access to monopoly networks under a system of informed economic regulation to determine terms and conditions of access to producers, retailers and consumers; and
- removal of legislated barriers to the inter-State trade in gas.

Whilst aspects of these reforms are underway they have not yet been concluded with the end result that there still remain inefficient costs in the energy sector at all points: generation, production, supply and transmission and impediments to investment.

It is important that the work of ERIG and the broader COAG energy agenda achieves a true national market.

4 THE BCA RESPONSE TO THE ERIG TERMS OF REFERENCE

This section of the submission highlights the experience of BCA Members who are in energy intensive industries in regard to the matters raised by ERIG, whilst the next section makes a number of recommendations to improve the current arrangements.

4.1 Achieve a fully national transmission grid including the most suitable governance and transitional arrangements giving consideration to matters such the "legitimate" commercial interests of asset owners and the need to promote investment

One of the key benefits of the move to a National Electricity Market was the promise of a single, national market, with separate regional markets connected by a strong national grid to ensure the capture of the benefits of robust competition by generators in one State selling excess capacity to offset excess demand in another State. Our Members believe this has occurred to only a very limited extent. Competition and lower prices require improved transmission and interconnectedness.

Discussions with a number of BCA Members who are major users of energy highlighted the following challenges with regard to transmission:

- The largest concern raised by our Members is that there is insufficient south east electricity interconnection to engender strong inter-State competition amongst generators and to ensure that the lowest cost generation is tapped. This is particularly the case for businesses located in South Australia where there is little generator choice but it is a problem in all markets.
- In South Australia and parts of NSW "bottlenecks" are occurring as demand increases and on occasion large users such as cement operations in South Australia and steel in NSW are having to reduce electricity use or cease particular operations during peak electricity demand periods. Such situations have impacts on production planning and meeting demand but in the longer term lead to questions about where to locate future capital investment in plant and production facilities.
- Companies believe that there are very poor locational signals for investment given the current regional structure.
- Bottlenecks and other constraints on the effectiveness of the transmission grid mean some companies are not able to take the benefits of spot trading. Currently there is not sufficient confidence in the transmission capacity for companies to enter the spot market.
- Companies with operations in many States seeking to negotiate a national electricity contract with a retailer find it difficult to do so as the electricity flows cannot be hedged across the different interconnectors.
- When energy intensive businesses are deciding on major investment in their future plant and facilities they need to take into consideration the capacity/availability of both generation and transmission to support these long term investments. There is insufficient information on such investments, particularly in transmission.
- Where there are major long term investment decisions and the business requires significant energy (electricity or gas) and the energy price and supply cannot be forecast with a reasonable level of confidence there is an inflated risk to be factored into the cost structure for the venture and therefore a higher hurdle rate to be achieved in the business case for the investment. In effect the lack of an appropriate transmission grid acts as an impediment to business investment.
- The varying and erratic responses across States to climate change are also contributing to a much higher risk premium on investment and uncertainty about

the availability of future generation (for example from the coal-fired generators in Victoria).

- Companies believe the regulatory “benefits test” does not recognise the wider benefits of transmission in the market.
- The current transmission network support regulation test may limit consideration of all possible generation projects.

4.2 Address structural issues impeding competitiveness and efficiency

Highlighted below are a number of structural issues raised by BCA Members.

Ownership of assets and perceived implications on investment

Where the State has only one owner of all their significant electricity generation assets and robust competition is limited there are both constraints on investment in infrastructure but also little opportunity to benefit on pricing. At a minimum outsourcing of the trading functions of the State owned entities should be considered if privatisation in not an option. Provided sufficient competitors can be attracted and the opportunity for exercising market power lessened through a more robust re-allocation of generating units in each trading entity, a more competitive market structure could be engendered by pursing the outsourcing option.

- Businesses operating in NSW have noted some major concerns with regard to future capacity due to the perceived underinvestment in generation and in infrastructure and maintenance and therefore the potential future unreliability of electricity supply.

Regulatory framework

A number of BCA Member companies noted that they were not able to attain the full benefits of a national energy market when negotiating contracts as a result of the regulatory arrangements which are still slow, cumbersome, inconsistent, and provide poor economic signals. This situation is made worse by the slowness in establishing a national regulator leading to the risk of higher regulatory and transactions costs for businesses operating across jurisdictions.

Pricing

BCA Members noted the current trend for some States to maintain controls on retail energy pricing acts as a brake on future investment.

It was also noted that the lack of a pricing signals with regard to demand acted against achieving efficiencies. Varying prices on the basis of on and off peak and/or season need to be considered.

4.3 Ensure there are transparent and effective financial markets to support energy markets

BCA Members noted that the development of financial markets has been limited to date. For example, there is insufficient participation by financial institutions and others in offering financial hedges. This situation gives generators considerable bargaining power in a region. It was felt by members that financial instruments could be improved and that they would work more effectively with different regional structures.

BCA Members believe it is also much too difficult to hedge between regions. This lessens competition within a region and means companies cannot gain access to the lowest cost generation.
Some Governments in Australia have continued to intervene in the market place by introducing schemes that insulate certain segments from price signals or protecting them by placing retail price caps. The Electricity Tariff Equalisation Fund (ETEF) operating in NSW, for example, not only places caps on retail prices charged to households, but its operations significantly distorts the wholesale market. It clearly reduces the amount of peaking capacity in the market.

4.4 Natural Gas

BCA Members identified two major challenges with regard to gas.

The first of these is the inadequate capacity of the Dampier – Bunbury gas line which meant that some businesses were reverting back to coal based electricity to ensure supply.

The second is the underdevelopment of the gas market including a lack of financial instruments to support the market. A major inhibitor to the effective operation of the gas market is the lack of real time data and settlements. If the market were more dynamic it would be possible to have an effective spot market.

5 RECOMMENDATIONS TO IMPROVE CURRENT ARRANGEMENTS

The discussion above highlights a number of areas where business is not achieving the benefits inherent in a fully functioning national energy market. Benefits such as increased efficiency and cost reductions would occur with the advent of increased competition and better functioning financial markets to support energy markets. However, to achieve these outcomes further reforms are required. These are outlined below.

Significantly improve transmission planning and make it nationally based

Currently transmission planning is state-based and too fragmented. The national energy market (NEM) wide benefits of additional transmission are given inadequate attention. The current annual national transmission statement (ANTS) process has not addressed this problem as it is high level only.

Allow for the consistent inclusion of competition benefits in the current regulatory test for transmission investment

Without their effective inclusion we believe there is a potential for systematic under investment in transmission.

Improve the firmness of inter regional financial trades by one means or another

The current settlement residue auction process is clearly not meeting its objective of assisting market participants to manage their price risk of trading between regions.

Move away from State-based regions in the NEM for settling prices

Regions must reflect market needs rather than political boundaries. Such a move would improve transmission investment and locational pricing, and reduce negative residues.

Remove government market interventions such as ETEF

At a minimum ETEF reduces market liquidity. It also reduces generation investment by artificially lowering prices overall and removing the incentive for investment in peaking generation.

Do not allow one company to own both transmission and generation assets

There is considerable potential for common ownership to see transmission investment and operation used for private gain at the expense of effective market operation.

Ownership of assets and perceived implications on investment.

At a minimum outsourcing of the trading functions of the State owned entities should be considered if privatisation in not an option. The objective is to ensure there are sufficient independent competitors that can be attracted and that the opportunity for exercising market power is lessened.

Ensure common and predictable greenhouse policies across Australia

Significant risk premiums are being built into investments to the detriment of the economy.

Create a more liquid and transparent gas market with more effective financial investments

We believe the efficiency benefits from such a move would be considerable.

6 CONCLUSION

National planning for and coordination of energy infrastructure is critical to Australia's economic growth. Bottlenecks and inadequate provision will lead to decreased productivity and competition.

The Council of Australian Governments must continue to ensure the development of forward looking and coherent strategic directions for national energy market development. The contribution of ERIG to this process should be substantial. The BCA looks forward to the next stage of energy market reform.