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Energy2031 Directions Paper  
Office of Energy  
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***Energy2031: Strategic Energy Initiative – Directions Paper***

The Energy Supply Association of Australia (esaa) is pleased to make a submission to the Directions Paper for the Western Australian Government's Strategic Energy Initiative, *Energy2031*.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of over 40 electricity and downstream natural gas businesses, including many with commercial interests in Western Australia. These businesses own and operate some \$120 billion in assets, employ over 52,000 people and contribute \$16 billion directly to the nation's Gross Domestic Product each year.

The Association has strongly supported the development of the Strategic Energy Initiative since its announcement in November 2009. Given that Western Australia's last comprehensive energy policy was in 1979, the Initiative is a timely opportunity to thoroughly review contemporary issues and future challenges facing Western Australia's energy sector and set out a strategic energy policy framework for the long term.

esaa welcomes the release of the Directions Paper as a step forward in this important process and considers that the many important reform ideas it identifies has laid a solid platform for the Government's final energy policy. The Association considers that the ideas in the Directions Paper should be refined in the final *Energy2031* document through prioritising the proposals and setting out in greater detail implementation strategies.

In the attached submission, the Association provides overarching commentary on the Paper and comments in response to the six themes and twelve strategies as they relate to stationary energy. Any questions about the submission should be addressed to Kieran Donoghue, by email to [kieran.donoghue@esaa.com.au](mailto:kieran.donoghue@esaa.com.au) or by telephone on (03) 9670 0188.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Brad Page', written in a cursive style.

**Brad Page**  
Chief Executive Officer

## Efficient Energy Market Principles

esaa supports the development of a secure, reliable, competitive and cleaner energy supply system, where open and competitive markets form the corner-stone of an efficient energy supply system.

esaa developed the following principles in its 2009 Western Australian Energy Market Study<sup>1</sup> to provide a framework for thinking about reforms that could best promote efficient outcomes in the state's energy market over the longer term.

These principles have provided a framework for evaluating the proposals in the Directions Paper and identifying priorities.

- 1 A secure, reliable, competitive and cleaner energy supply is best achieved by balancing the roles of government, the private sector and markets.
- 2 Markets should be the primary mechanism for coordinating the production and consumption of energy services.
- 3 Markets work best when they are competitive: there should be no unnecessary barriers to entry or exit; prices and quantities traded should reflect prevailing supply and demand conditions; and market information should be transparent and accessible.
- 4 Where government intervenes or regulation is applied, it should: be targeted, proportionate, transparent and consistently applied across market segments; be independently applied, monitored and enforced and open to review; promote competition, innovation, efficiency and reliability; and be of net benefit.
- 5 Regulation of the monopoly parts of the system should facilitate competitive market outcomes, timely investment, innovation and reliable energy supply.
- 6 Where prices are administratively determined, they should ensure full recovery of efficient costs and promote innovation.
- 7 Where costs are administratively allocated, the 'causer pays' or 'beneficiary pays' principles should be applied as appropriate.
- 8 Where the market is not appropriately delivering the community's social objectives, the government should explicitly describe and directly fund separate measures.

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<sup>1</sup> This study has been previously provided to the Office of Energy, but we have included a copy with this submission for ease of reference

## **General comments**

The Association makes the following overarching comments in response to the Directions Paper. These provide the context for the more detailed comments made on the specific proposals in the six themes and twelve strategies in the Directions Paper in the subsequent part of this submission.

### Reaffirming a competitive, market driven energy sector

While Western Australia's energy sector has historically been highly directed by governments – as in other Australian jurisdictions – reform processes in recent decades have begun to shift responsibility for coordinating the supply and demand for energy away from governments to markets.

However, this process is relatively recent and compared to most goods and services in the broader Western Australian economy, the production, transport and consumption of energy is still subject to extensive government involvement and regulation.

Western Australia's energy sector also has a range of challenges to manage that tend to suggest a role for governments. These challenges include considerable dependency on a single fuel, reliance on key pieces of infrastructure, a large land mass with sparse population, and islanded electricity systems. Similarly, the state's broader objectives beyond energy policy – such as state development – may at times require greater involvement from government.

Given these challenges and the fact that the sector's reform process remains incomplete, a fundamental question that continues to confront energy policy in Western Australia is: What is the long-term goal for the sector? Is it a sector where markets and decentralised, commercially-based decision-making predominate? Or is it a sector where government direction remains a strong feature?

As stated in the Efficient Energy Market principles, esaa considers that markets should be the primary mechanism for coordinating the production and consumption of energy services. The key advantage of markets is that they do not require central planners to allocate resources; rather, they consolidate the myriad decisions and actions of producers and consumers into prices that reflect prevailing supply and demand conditions, and then allow these prices to guide production and consumption decisions. This approach is consistent with esaa's guiding philosophy that open, competitive energy markets should be the cornerstone of Australia's stationary energy supply system.

As such, the Association strongly urges the Government in the final Strategic Energy Initiative to reaffirm that the enduring direction of energy policy is towards strengthening the role of competitive markets as the key to an efficient energy supply system for Western Australia for the long term. Such a commitment will provide important direction for industry and establish the foundation for the panoply of other reforms contained in the Directions Paper.

However, in light of the unique energy security challenges facing the energy sector and the state's broader objectives, at times it will be necessary for energy policy to

deviate away from this principle. This necessity is reflected in esaa's first Efficient Energy Market principle, namely, that achieving a secure, reliable, competitive and cleaner energy supply requires *balancing* the roles of government, markets and the private sector.

How the government's involvement in the energy sector occurs is a matter of judgement and will depend on specific circumstances as they arise. However, the Association encourages the Government to be guided at these times by an overarching and enduring policy commitment to strengthening the role of markets, and as such, ensure that its involvement in the energy sector when required minimises both short- and long-term distortions to the operation of markets and preserves a conducive environment for businesses to operate.

#### Prioritisation and detail on implementation are needed

The wide scope of issues addressed in the Directions Paper demonstrates that the Strategic Energy Initiative is being developed at a crucial stage in the development of Western Australia's energy markets – important reforms have begun but are incomplete and new issues have emerged to join enduring challenges that remain unresolved.

However, the Association notes, that with six themes, 12 strategies and around 100 separate actions and options, the breadth of ambition in the Directions Paper is considerable.

Further, for many items there is little or no detail on how the Government intends to implement its ideas, including detailed specification of the proposal, assignment of responsibilities, timelines for delivery and articulation of how the proposal would interact with other proposals in the Directions Paper.

This combination of an ambitious agenda with sparse implementation detail raises concerns about the capacity of the Government's agenda to be fully implemented.

As such, esaa strongly encourages the Government, in its final *Energy2031* paper, to focus on delivering a more targeted and robust energy policy by limiting and prioritising the actions to be delivered. Additionally, the final document should set out a coherent plan for how the ideas fit together. In the remainder of this submission a number of priority areas are highlighted for the Government's consideration.

Further, to provide guidance and confidence to the energy industry, it would be beneficial if having identified priority policies in the final Strategic Energy Initiative, the Government also articulated them in more detail than is currently in the Directions Paper and then specified how Government intends to implement them, including resourcing.

To the extent that the final document, which is due in mid-2011, is unable to fully flesh out policy ideas and outline implementation strategies, the process for subsequent policy development should be made clear. The Association strongly encourages the Government to consult closely with industry in any subsequent processes, and throughout implementation.

### Policy coherence is key

One of the strengths of the Directions Paper is that it addresses a broad span of issues. The approach of the Directions Paper to identify a number of key themes and then strategies within each theme is useful to delineate important issues. However, given the interrelated nature of energy market issues, the breadth of coverage also highlights the importance of ensuring that the final Strategic Energy Initiative delivers a coherent policy agenda.

The linkages between actions in different themes/strategies must be properly understood and factored into the final policy document, especially once the policy ideas have been prioritised and implementation issues are considered in more detail. Some examples of the policy linkages that must be considered include:

- Reforms to electricity tariffs feature in a number of strategies (Themes 2, 3, 5 and 6) and hence consistency across the recommendations is important to ensure that tariffs are not being reformed in different directions to achieve conflicting objectives.
- Reforms to network planning arrangements (Theme 2) could have implications for the wholesale market (Theme 5), such as the reserve capacity mechanism, and such inter-relationships must be identified and considered in final recommendations.
- Enhancing the state's energy efficiency (Theme 3) requires appropriate and transparent price signals, which in turn requires electricity tariff reforms to achieve cost-reflectivity (Theme 5).
- Many of the proposals in the Directions Paper could increase the cost of energy supply, at least in the short term (e.g. proposals to enhance reliability standards in Theme 4). These will have the implications of making the transition to cost-reflective tariffs more difficult (Theme 5) and may increase pressures on energy affordability for some consumers (Theme 6). Resolving these tensions will require a clear delineation between efficient energy policy and social policy, as discussed below.

In addition, identifying the logical sequence of reforms is necessary for a sensible energy policy blueprint. Successful implementation of certain strategies in the Directions Paper is contingent on prior implementation of other strategies. For example reforms to increase competition in the retail electricity market requires significant preceding reforms to create conducive conditions, such as eliminating non-cost reflective tariffs and establishing an appropriate price setting process.

Lastly, the Association urges the Government to be mindful of existing institutional processes, such as the Independent Market Operator's (IMO) Wholesale Electricity Market (WEM) development process, and to seek to deliver its reforms through such vehicles where possible. It is also crucial to maintain consistency and mutual understanding of the reforms between the various agencies that will have a role in implementing them.

### Improving price signals is a priority and attaining cost reflectivity is a pre-requisite

As stated above, esaa supports markets as the primary mechanism for coordinating the production and consumption of energy services. The key to well-functioning markets is efficient and transparent prices.

Price signals are powerful tools to shape behaviour and are a fundamental aspect of resource allocation in almost all aspects of the Australian economy. Price signals have the potential to improve the efficiency of the energy system, including improving system utilisation by providing signals for time of use consumption, informing rational decisions on energy efficiency or responding to emissions reductions objectives through carbon pricing. This potential is recognised in the Directions Paper, where improving prices signals throughout the supply chain, including retail and network components, features in a number of themes and strategies.

The Association strongly supports improving price signals as a priority in the final *Energy2031*.

For energy prices to be effective in encouraging an efficient energy system an essential prerequisite is that they are cost reflective. As is well-understood, electricity prices for some customer classes are below cost in Western Australia. Therefore, to lay the foundation for a future energy system that takes advantage of the power of price signals, energy prices must become cost reflective as a matter of priority.

The Association notes that the Government has made efforts to restore prices to cost-reflective levels. The Association supports these efforts and encourages the Government to continue this process.

The cost of energy supply in Western Australia, as in all jurisdictions in Australia, is increasing currently. There are a number of reasons for this: rising fuel costs, the cost of meeting federal and state government policies that mandate more expensive forms of renewable energy, rising network costs due to peak demand growth and other factors, and depending on the shape of federal greenhouse policy, likely carbon costs.

The Association notes that increasing energy prices is politically challenging, and that increasing energy costs provides additional challenges as prices must catch up to a 'moving target.' However, as shown in the Verve Energy Review, trying to constrain costs through holding down prices is self defeating as costs can not be made to disappear; rather they are just moved to somewhere else in the system. As such, the Association urges the Government to continue the process of transitioning prices to cost-reflective levels as a prerequisite to sharpening price signals and enabling many of the other reforms relating to price signals in the Direction Papers to occur.

Further, as the detail of federal greenhouse policy becomes clear the Association urges the Government to examine the interaction of carbon pricing (and any attendant household compensation package) with energy tariffs and price signals. In particular, to ensure that consumers receive appropriate price signals to encourage efficient abatement and that businesses are able to recover their increased carbon costs, it is important that mechanisms are in place to ensure that the carbon price

can be passed on efficiently and promptly, both during any fixed carbon price period and any subsequent floating price period.

### Gas market constraints

While esaa supports the development of open, competitive energy markets free from distortions such as retail price regulation, the Association acknowledges the existence of a range of wholesale gas market rigidities which in their entirety, can inhibit progress towards a fully competitive retail market. Current characteristics of the Western Australian wholesale gas market are outlined as follows.

- Limited diversity of supply: The North West Shelf (NWS) Project continues to dominate natural gas supply to domestic customers in Western Australia, supplying a maximum sustainable capacity of almost 600TJ/d in 2010, or around 60 per cent of total supply. While the prospects of higher gas prices, driven primarily by Asian LNG demand, have led to further exploration and the identification of additional resources, a general lack of diversity amongst producers means that adequacy of supply and thus, the ability of domestic gas buyers to achieve long-term contracts at competitive prices is not guaranteed.
- Infrastructure capacity constraints: Domestic gas processing capacity has continued to tighten in Western Australia since around 2004, which coupled with limited options for the transportation of gas from the main sources of supply, has the potential to constrain supply and thus create inefficient price outcomes.
- Long-term contracting: There is a heavy reliance on long-term contracts, which leads to a lack of price transparency and less flexibility to adjust volumes compared to a situation where there is a spot market on which additional volumes may be bought or sold.
- Increasing energy costs: The reported increase in the price of long-term gas contracts could deter entry into the retail market where incumbents are still benefiting from lower prices agreed in previous years.

Guided by the principle that markets work best when they are competitive, in the longer-term, a secure, reliable and competitive supply of gas to Western Australia's domestic market would be best promoted through the development and introduction of policies which target market failures that have contributed to the state's domestic gas shortage and enable competitive market outcomes to prevail. If these reforms are effective in promoting competition in Western Australia's wholesale gas market and allow the unconstrained entry of new energy businesses into the retail gas market it would be expected that requisite market conditions for removing regulated tariffs will prevail.

### Greenhouse policy

The response to carbon pricing looms as one of the key challenges confronting Western Australia's energy sector over coming decades.

A carbon price will have significant implications across the energy supply chain. Many of these are identified in the Directions Paper. Such challenges include the

additional pressures on energy costs for end users, changes in incentives to invest in lower emissions technology options and changed geographic patterns of generation, which will have implications for network requirements.

The Association notes that while such challenges from a carbon price face all of Australia's energy sectors, Western Australia's particular circumstances provide an additional set of challenges. In particular, endemic gas availability issues will have implications for the relative merits of gas versus other fuel sources, such as coal, and hence the ability to achieve abatement through fuel switching at the generation level.

The implications of the interaction between gas issues and carbon policy is difficult to predict, especially given the current acute uncertainty about the shape of federal climate change policy. This uncertainty complicates the Western Australian Government's current task of making energy policy. However, a greater understanding of the possible impacts of carbon pricing on the Western Australian energy sector is necessary to provide guidance to industry and policy makers alike.

One tool to explore uncertain future impacts is economic modelling. The Association notes that the Strategic Energy Initiative's modelling component has not been released in time for consultation on the Directions Paper. This quantitative base of information would have been useful for stakeholders to consider longer-term challenges. esaa encourages release of the modelling as soon as possible to inform ongoing debate.

As set out in our response to the Issues Paper, the Association supports national climate change policy measures to reduce Australia's emissions and encourages Western Australia to be consistent with national approaches.

Once greater policy clarity is provided at the national level, the Association encourages the Western Australian government to examine in greater detail the implications of carbon pricing on Western Australia's energy sector, taking account of its particular challenges. Depending on timeframes, this may occur in either the final *Energy2031* document, any subsequent policy development processes, or the annual audits/triennial review processes for the Strategic Energy Initiative.

#### The North West Interconnected System and other regional energy hubs

While the Directions Paper touches on the North West Interconnected System (NWIS) and emerging regional energy hubs in a number of its action items, the Association considers that this is an area where the final Strategic Energy Policy document would benefit from significantly more attention.

In particular, in light of the current unregulated and uncoordinated state of the NWIS, the proposal in Theme 5 to consider the merits of extending the WEM to incorporate the provision of power supply in the NWIS, while potentially a relevant question in the longer term, is premature at this stage and does not address the fundamental issues.

The Association's Western Australia Energy Market Study considered in detail the challenges facing the NWIS and discussed how, given the current unregulated state of that system, the Government faces choices in how to approach reform in the NWIS. This choice can be characterised as a spectrum between continuing a minimalist approach that relies on informal and voluntary frameworks or moving

towards a heavier-handed approach, built on formal, compulsory frameworks and mechanisms.

esaa considers that the Government must recognise and commit at a basic level that it must first take a stronger role in the planning and operation of remote systems, rather than to let them continue to develop in an ad hoc fashion. Clear articulation of this principle in the final *Energy2031* is the necessary foundation upon which any subsequent reform and state development objectives can be considered, such as implementing WEM-style market arrangements.

## **Comments on themes/strategies**

The Association makes the following more specific comments on the six themes and twelve strategies in the Directions Paper. In light of the high level nature of a number of the actions and options described in the body of the Directions Paper, and the lack of detail with respect to implementation, these comments do not respond to all of the 100 or so items. Further, they are high level and focus on key issues and priorities. These comments should be considered in conjunction with esaa's Efficient Energy Market principles and the overarching comments above.

### ***Theme 1: Security of energy supplies***

#### Energy supply diversification strategy

Security of energy supply is a high priority in public policy. As outlined in esaa's submission to the Initiative Issues Paper, a particular impediment to the security of energy supply in Western Australia is the dependence of the state on gas supplied from the Carnarvon Basin and key pieces of gas infrastructure.

Diversifying energy supplies, including across fuel types and supply sources, is a logical response to energy security risks posed by concentration of supply sources. The Association supports a diversification of Western Australia's energy supply. The key question is how is such a diversification achieved?

Given the imperative of energy security, energy supply diversification may be an area where the tension described above between the role of markets and the involvement of the government in the energy sector emerges. This tension needs to be carefully managed to preserve the primacy of markets while at the same time ensuring energy security. The Association encourages the Government, in its final policy document, to clearly articulate and explore the implications of the policy tension.

The Association considers there are areas where the government can play a strong role in facilitating markets to deliver a diversity of supply. Many of these areas are reflected in the options and actions listed under this strategy, including establishing efficient regulatory frameworks and standards (Items 7, 10), removing unnecessary barriers to entry or other commercial behaviour (Item 2), providing information to the market (Items 1, 5), encouraging skills and training (Item 3) and supporting R&D (Items 4, 6, and 12).

However, as a fuel and technology neutral organisation, esaa does not support measures that artificially favour (or penalise) particular energy supply options. As such, the Association suggests that proposals to develop market rules that provide incentives for hybrid renewable/conventional generation facilities, as per Item 8, be explored through the existing market review process as overseen by the IMO to ensure thorough analysis and appropriate industry consultation.

#### Gas security strategy

The Association supports the view expressed in the Directions Paper, namely that current policy settings and programs may not ensure that future natural gas demand is appropriately met, largely due to anticipated gas supply limitations.

As previously outlined, a suite of coherent and complementary policy measures is required to address the critical wholesale gas market constraints identified and facilitate a competitive, secure and reliable gas market. As a result, it should be noted that any policy measures considered in the context of energy security will also impact significantly on competition in the wholesale gas market and so should also be viewed in the context of facilitating competitive energy markets. Accordingly, the Association has given consideration to the following policy measures with respect to not only ensuring security of supply, but also facilitating competition within the wholesale gas market: petroleum retention leases; petroleum royalties and taxation; the domestic gas reservation policy; joint selling and marketing of gas; gas storage; Short Term Trading Markets; and processing capacity. Please note that while gas transportation is also relevant to security of supply, this matter has been addressed in response to Theme 2.

#### *Petroleum retention leases (Item 1)*

The Association agrees that exploration for gas in deep water is a high-risk commercial activity and is appropriately supported by providing greater certainty of tenure over field discoveries. However, the undefined and potentially narrow assessment of commerciality in retention lease applications and a lack of third party participation and transparency in the process may subdue obligations on producers to bring commercially viable gas resources to production.

esaa considers that the Initiative should seek to promote use-it-or-lose-it contestability in tenured gas resources by advocating that the Commonwealth Government institute a range of reforms over the short term to improve the management of retention leases and by working with the Commonwealth Government over the medium term to explore whether there are other appropriate avenues to further promote use-it-or-lose-it contestability such as auctioning.

#### *Petroleum royalties and taxation (Items 1 and 4)*

As outlined within the earlier submission, the Association considers that the Initiative should seek to transition Western Australia's value-based royalties framework into better alignment with the more efficient profit-based framework applying to gas projects in Commonwealth waters, providing the overall tax burden is not increased. In addition to improving the timing of taxation liabilities with project cash flows, the harmonisation of state and federal taxation and royalty arrangements should assist in incentivising onshore exploration for gas resources. The Association further considers that the determination of an appropriate royalty rate to apply under an alternative framework should be guided by the Government's general objective to facilitate the development of the State's gas resources.

#### *Domestic gas reservation policy (Item 2)*

Since it is unclear as to whether or not LNG producers would commit to providing the level of domestic gas processing capacity needed to produce volumes and prices more consistent with a well functioning wholesale market, the Association considers that the domestic gas reservation policy will play an important role in bringing gas to the domestic market over the medium term. However, the variable application of the gas reservation policy by Government can create uncertainty in the domestic gas

market, which increases risks for LNG producers subject to domestic gas obligations as well as for domestic gas producers and consumers trying to anticipate alternative sources of supply.

As such, while ever the Government continues to apply a gas reservation policy, the Association is supportive of measures which ensure that it is applied in a manner that promotes certainty and allows predictability of new supply in the domestic market.

#### *Joint selling and marketing of gas*

Joint selling and marketing of gas was not explicitly referred to within the Directions Paper. However, given the potential impact of joint marketing arrangements on the level of competitive tension between gas producers, it is the Association's view that such arrangements should be taken into consideration.

In 2010, the Australian Competition and Consumer Commission (ACCC) granted authorisation for the North West Shelf Joint Venture to have its joint marketing authority re-instated, citing that the Western Australian market had not developed sufficiently over the last decade to make separate marketing of incremental volumes of gas from the North West Shelf partners a viable prospect. The ACCC did however, acknowledge that suitable market conditions may evolve in the medium term – including increased competition amongst suppliers, increased storage capacity and secondary trading – and as a result, authorisation was only granted to the North West Shelf Joint Venture out to 2015.

The Association recognises that oversight of the ACCC and administration of national competition law resides with the Commonwealth Government, but considers that the Western Australian government can take steps towards the emergence of those market conditions referenced by the ACCC by the introduction of appropriate reforms to facilitate greater competition amongst suppliers and improve the overall transparency and liquidity of the state's wholesale gas market. This approach should remove the case for joint selling and marketing in the future and allow the government to pursue the elimination of the joint marketing authority currently granted to the North West Shelf Joint Venture when applications come up for renewal in 2015.

#### *Gas storage (Item 3)*

Gas storage, including line-pack capacity and dedicated storage facilities, are critically important for ensuring the reliability of energy supply by providing system backup and mitigating the consequences of supply disruptions. The Association supports the development of initiatives which encourage greater investment in gas storage facilities, noting that the costs of storage should be allocated to those who benefit. Furthermore, opportunities to encourage wholesale trading of gas storage should also be considered.

#### *Short Term Trading Market (Item 3)*

The Association is supportive of the Initiative giving consideration to the implementation of a Short Term Trading Market for gas in Western Australia following a review of the first two years of operation of the planned Gas Bulletin Board and the response to the Gas Statement of Opportunities. Open short-term trading by market

participants could enhance price discovery, increase trade disclosure, facilitate market entry, improve customer choice, signal investment requirements, provide avenues for risk management and reduce barriers to entry in upstream and downstream markets.

esaa considers that a decision on whether this form of market intervention is appropriate should be determined by cost-benefit analysis. Furthermore, a decision on whether government involvement in facilitated trading is appropriate should be guided by an assessment of potential market-based solutions.

#### *Processing capacity (Item 5)*

Despite proposed future expansions in gas processing capacity, a lack of investment in new capacity since around 2007 is indicative of a market lacking transparency, particularly since the Gorgon processing facility – which represents over 40 per cent of the new committed capacity – is only being constructed as part of the domestic gas reservation obligations underpinning the Gorgon LNG project.

While the Association is broadly supportive of measures that incentivise investment in common user processing infrastructure, it is only supportive to the extent that the costs are allocated to those who benefit. Further, esaa considers it more appropriate to address the market failures that have led to a lack of investment in effective processing capacity, namely a lack of price transparency and the absence of effective wholesale and secondary gas markets.

## ***Theme 2: Ensuring efficient provision and utilisation of energy infrastructure.***

### Energy Infrastructure access strategy

esaa supports the objective articulated in the Directions Paper of ensuring essential energy infrastructure is designed, augmented and used sustainably to promote competition and efficient investment.

While a constrained network access model (Item 1a) has the potential to improve the efficiency of the network, it is a significant reform that entails a number of complex elements that must be considered prior to any changes being made. These include: connection charging regimes; property rights for incumbents and new entrants; transmission access arrangements; locational signals; and the interaction between a constrained network and the Reserve Capacity Mechanism.

As such, before any model can be introduced, the potential reform must be considered carefully and holistically with the broader energy market to assess the impact on all stakeholders, including the network operator, generators, retailers and customers. Issues must be identified and resolved prior to implementation, including through close industry consultation. esaa urges the Government to allocate the necessary resources to this reform project to ensure that any transition provides industry with clarity, promotes investor confidence and helps prevent legacy issues in the future.

As set out in the submission to the Strategic Energy Initiative Issues Paper, the Association supports examining the merits of a constrained network access model for the Western Power transmission network (Item 1a).

The Association reiterates the comments from the earlier submission that while this reform has the potential to improve the efficiency of the network it entails a number of complex elements – such as the interaction with the Reserve Capacity Mechanism. As such, the reform must be considered holistically with the broader energy market and issues must be identified and resolved prior to implementation, including through close industry consultation. esaa urges the Government to allocate the necessary resources to this reform project to ensure that any transition provides industry with clarity, promotes investor confidence and helps prevent legacy issues in the future.

As previously noted, the supply of domestic gas in Western Australia is heavily dependent upon key pieces of gas infrastructure, namely the Dampier Bunbury Natural Gas Pipeline (DBNGP). Where access to this transportation infrastructure is largely constrained – as is the case for the DBNGP pipeline to around 2019 – impediments to the development of efficient wholesale and retail gas markets are created. Consistent therefore with the recommendations from the earlier submission, the Association believes that the Initiative should, over the short term, consider options to promote greater and more responsive investment in gas transportation, including an assessment of the impact of access regulation and opportunities to encourage secondary trading of gas transportation. These initiatives, coupled with investment in gas storage capacity, could improve the ease with which gas producers can increase supplies in a timely manner, thus underpinning the development of a Short Term Trading Market.

### Smart grid strategy

esaa's Efficient Energy Market principles state that where regulation is applied, such as network pricing, it should promote innovation. Smart grids are an emerging set of technologies and innovation in this area holds significant potential to address the challenges for the energy sector, such as facilitating more sophisticated price signals and other mechanisms to manage peak demand. However, smart grids are still in the demonstration stage and accordingly, the quantum and full range of potential benefits are unknown at this stage. This will provide challenges for the regulatory framework.

As such, the Association supports the recommendations in this strategy to ensure that appropriate regulatory incentives are provided for the development of smart grids and that research and development into the smart grid design parameters that are most appropriate for the Western Australian system are supported (Items 1 and 2).

Given the significant uncertainties about the future shape of the energy system, developing the details of the government's smart grid strategy over the coming years is likely to be an evolutionary process. The Association encourages the government to consult industry (both network service providers and other affected businesses), regulators and consumers during this process. Such dialogue and consultation will be important to ensuring that stakeholders are involved in the future development of the energy system and will enable the identification and resolution of any issues or frictions that emerge as the technological and economic possibilities of smart grids are developed.

### Peak demand reduction strategy

As noted in the Directions Paper, the cost of meeting peak demand is adding to the overall costs of energy supply. The Association supports efficient measures to reduce peak demand growth and improve system utilisation.

In particular, as outlined above, price signals are a powerful way to change behaviour, including consumption patterns. As such, the Association supports Items 1 and 2 that propose to improve price signals by reflecting the costs of providing peak capacity. Education campaigns such as proposed in Item 4 can also augment the power of price signals.

However, as noted above, transitioning energy tariffs to cost-reflective levels will provide a sensible starting point before increasing the sophistication of price signals to achieve load shifting objectives. Furthermore, before such nuanced tariffs can be implemented, significant detailed work will be required, including with respect to metering capabilities. Western Power will shortly be subject to a review of its costs for the next five years, in which time up to a third of meters in the SWIS will require replacement. It is important to decide before its revenues are set what functionality will be required from these new meters. The Association stresses the importance of close engagement with industry and securing community acceptance as implementation strategies are designed.

The Association notes that as time of use tariffs are deployed, concerns may emerge about the ability of certain households to manage the new tariffs. However, as

outlined in more detail in its response to Theme 6, such energy affordability concerns should be dealt with without compromising the underlying price signals.

Regarding the proposal to review the design of the wholesale market in Item 3, the Association notes that little detail has been provided on what this entails. The Association would caution against changing the design of the wholesale market to achieve one objective – peak demand reduction – without undertaking holistic analysis to assess the impact on other wholesale market objectives. As such, consistent with the broader need for coherence in energy policy, any such review should be explored through the existing market review process as overseen by the IMO to ensure thorough analysis and appropriate industry consultation.

### ***Theme 3: Improving the energy efficiency of the Western Australian economy***

#### State energy efficiency strategy

The Association supports an efficient energy system. To achieve this, it is important that efficient outcomes occur on both the supply and demand side of the market. With respect to the demand side of the market, esaa considers that energy efficiency is an important strategy available to energy consumers to optimise their energy use.

The Association considers that decisions about the best way to achieve cost-effective energy efficiencies will generally be best made by energy users, as they are the only ones who have the knowledge to fully take account of their own circumstances.

Like most economic decisions, energy efficiency involves making tradeoffs. Often this involves substituting increased capital to enable a reduction in energy consumption. As such energy efficiency strategies are not costless – however, where they are rational, the ongoing energy savings from reduced consumption are sufficient to offset the increased, usually upfront, capital costs.

The Association endorses energy efficiency as a goal of the Strategic Energy Initiative. The first step to improving the energy efficiency outcomes of the Western Australian economy is facilitating consumers to make rational decisions about energy efficiency investments. Given the nature of the tradeoffs involved in energy efficiency decisions, this objective requires improving the efficiency and transparency of price signals.

However as energy prices are currently below costs for some users, those users cannot be expected to make rational energy efficiency decisions as the information they have is distorted. More specifically, below-cost prices will lead to the levels of energy efficiency being too low.

As such, improving the energy efficiency of the Western Australian economy provides additional impetus to the imperative of transitioning energy prices to cost-reflective levels. The Association would also support the real cost of energy supply being included in customers' power bills with subsidies, rebates and concessions separately identified to improve the transparency of price signals, as per Item 6.

Once consumers are supplied with accurate price signals, there may be circumstances where additional government involvement is required to support rational energy efficiency decisions. For instance, consumers may require access to better information about potential energy efficiency opportunities, or they may need greater encouragement to engage with these decisions, or in some cases need financial support.

Such a set of strategies is alluded to in Item 5, which proposes developing and implementing a range of economically efficient measures to help significantly improve energy efficiency in the State, which complement national measures and include a combination of mandatory measures, voluntary measures and the provision of information and incentives.

Consistent with its Efficient Energy Market principle 4, the Association supports such strategies to the extent that they effectively target the issues, are proportionate, promote competition, innovation, are of net benefit and do not impose an excessive regulatory burden or duplicate other requirements.

However, the Association cautions against Western Australia adopting an approach that presumes that energy retailers should bear the primary responsibility for delivering energy efficiency and mandate specific behaviours (as has been adopted in other jurisdictions in Australia, which typically involves pushing the costs of energy efficiency initiatives onto other parties, often other consumers).

Instead, innovative and enterprising energy efficiency outcomes are more likely to emerge if the suite of energy efficiency policies that is implemented is directed at equipping consumers, both financially and with information, to demand cost-effective energy efficiency solutions. Then many diverse types of suppliers, including appliance manufacturers and retailers, construction companies, insulation providers, energy consultancy providers as well as energy retailers and networks will compete to meet this demand. Companies not traditionally associated with any of these sectors may also enter the market, such as consumer IT service providers. These incentives will sharpen as Western Australia's energy market continues to develop and competition increases.

#### ***Theme 4: Maintaining continuity of downstream energy supply***

##### *State energy continuity strategy*

The Association considers that the objective in this strategy has highlighted an important reality in energy supply systems – namely that there is a trade off between reliability and cost. The implications of this trade off should be borne in mind in developing energy policy in general.

It is particularly relevant with respect to the transition of tariffs to cost-reflective levels as it demonstrates that the high levels of energy supply reliability that consumers receive comes at a cost, and these costs should be paid for in energy prices. As such, to deliver an efficient energy system, the cost of any changes in reliability standards resulting from Item 1 or the cost of enhanced maintenance or additional back up generation (Items 2, 3 and 4) should be allowed to be passed into energy tariffs.

This strategy also recognises another of the trade offs that occurs in public policy, that between energy objectives and environmental objectives (Item 5). While acknowledging the state's legitimate role in resolving conflicts between these two objectives, as set out in the Association's Issues Paper submission, it is important that Western Australia's approach to emissions reduction be part of national measures in order that greenhouse objectives are achieved at least cost.

##### *State energy disruption management strategy*

Following two gas supply disruption incidents in 2008, the Western Australian Government established the Gas Supply and Emergency Management Committee to review and provide advice to Government on the State's gas security, gas supply disruption management and mitigation options. As outlined within Item 1, these recommendations include the introduction of funding measures to: facilitate the development of fuel storage facilities; and incentivise investment in dual-fuel equipped electricity generation facilities.

esaa acknowledges the recommendations of the Gas Supply and Emergency Management Committee (Item 1); however it is noted that further information is required in relation to the proposed funding mechanisms, particularly with regard to: the overall effectiveness of the proposed funding mechanisms; and the ability of energy supply businesses to pass through the overall financial impost of such mechanisms to those who benefit from them. Furthermore, given the Association's status as fuel and technology neutral, esaa does not support any measures that artificially favour (or penalise) particular energy supply options.

With respect to Item 3, consistent with the Association's status as fuel and technology neutral, the Association suggests that proposals to develop market rules that provide incentives to increase demand response when the system is under stress, be explored through the existing market review process as overseen by the IMO to ensure thorough analysis and appropriate industry consultation.

## ***Theme 5: Ensuring effective and efficient downstream energy markets***

### *Competitive energy and market development strategy*

The Association broadly supports the actions and options in Theme 5 and has commented substantively on the development of competitive energy markets in its Western Australia Energy Markets Study (the Study), which has previously been provided to the Office of Energy. As the Government develops the implementation of the Initiative, the Association encourages it to bear the findings of this Study in mind (it is included with this submission for ease of reference).

esaa supports Item 1, namely the continuation and evolution of present market arrangements, including the pursuit of competition and transparent public and market consultation. The Association considers that the reform process should continue to operate through established energy reform processes, such as the IMO's process for WEM reform.

With respect to reviewing the WEM (Item 2), the IMO's institutional process should be the primary vehicle for any reforms in this space. However, the Association suggests that at this stage investigating whether to move the WEM to a gross or net pool market, as set out in Item 2a, is not a short-term priority compared to other market reforms. As set out in esaa's Study, the Association considers that a review of the appropriateness of the WEM market model is a worthy exercise, but it should be considered in the longer term once more pressing short-term reforms are resolved. Specifically, the priority should be those issues that have been identified in the IMO's market reform processes e.g. reforms to introduce competitive balancing and ancillary services.

With respect to reviewing the Reserve Capacity Mechanism (RCM) as per Item 2b, the RCM is being considered under the IMO's Market Evolution Program. The Association notes that Item 1a in the Energy Infrastructure Access Strategy under Theme 2, which refers to developing a constrained network access model, would have implications for the operation of the RCM. As noted above, the Association supports exploring the merits of a constrained access model and to the extent that this is pursued following cost benefit analysis, the inter-relationships with the RCM should be examined to ensure policy coherence.

The Association notes that downstream energy markets are relatively young in Western Australia and that reforms are still ongoing. As noted above, esaa supports the Strategic Energy Initiative cementing the direction of energy policy towards strengthening the role of competitive, efficient markets as the corner-stone of an efficient energy supply system for Western Australia for the long term.

The Association considers that as the market continues to grow and regulatory barriers to competition are withdrawn, a less concentrated, more competitive energy industry structure should be a longer-term objective of the Western Australian Government. Achieving this objective has many inter-related facets and articulating a coherent pathway to this goal should be a key part of the final Strategic Energy Initiative.

With respect to retail competition, the Association supports the removal of barriers to competition and the establishment of full retail contestability for all customer classes in the SWIS for electricity and gas as an objective of the Initiative (Item 3). However, given current wider market and regulatory conditions, this goal cannot be achieved in isolation. It is important that the Strategic Energy Initiative puts forward a coherent policy agenda to establish the prerequisites steps and supporting conditions before increases in retail competition can be achieved.

A critical part of this, as mentioned above, is transitioning regulated electricity and gas tariffs to cost-reflective levels as soon as possible to provide potential new entrants an opportunity to earn reasonable returns.

The Association strongly supports the intent of item 7 to decouple mechanisms to achieve social equity assistance from the level of energy tariffs as linking the setting of energy tariffs to social outcomes will prove a roadblock to any form of pricing reform.

In the absence of full retail contestability, retail price regulation may be warranted. However, for price regulation to be effective and efficient, there should be a consistent, independent and predictable price setting methodology, administered by an appropriately independent body (such as the Economic Regulation Authority), that allows recovery of the efficient costs to supply energy and the cost of all legal requirements, including the cost of climate change policies. This is important to provide confidence for potential future participants considering entering the retail market. More broadly, new entrants to the market must have the confidence that the Government is committed to a market-based energy sector that will be free from unwarranted government direction. Without these pre-conditions, increases in the level of retail competition are unlikely.

Looking to the longer term, esaa's well-established policy position is that where contestability is enabled in retail markets, price regulation should be removed. While as noted above preceding steps are required to create these conditions in Western Australia, the Association strongly supports the Western Australian Government identifying price deregulation as an explicit longer-term policy objective. As such, the Association strongly supports the sentiment in Item 6 regarding the eventual phasing out of regulated tariffs as a marker to guide policy in the longer term, and reiterates the importance of setting out a logical reform pathway to this objective.

With respect to the other longer-term ideas listed in the Directions Paper – such as integrating the WEM into the National Electricity Market (Item 11) and physical interconnection to national markets (Item 14) – the Association supports these items being included as longer-term touchstones, but notes that there are more pressing priorities to be addressed first.

## ***Theme 6: Ensuring universal access to essential energy supplies***

### *Affordable energy strategy*

Access to energy is an important social objective. The Association supports the objective in the Directions Paper, namely to ensure all Western Australians can afford sufficient energy to meet their basic human needs, while eliminating inefficient cross-subsidies and ensuring that suppliers receive an adequate return to maintain and improve energy services.

The key policy question for *Energy2031* is therefore what is the best way to achieve sufficient levels of access to energy to meet community expectations?

In the past, governments have tried to achieve social objectives with respect to energy by limiting the price of energy. However, as has been clearly demonstrated in Western Australia, this approach is self defeating as costs must ultimately be recovered. Holding energy prices to levels below cost is a very blunt measure that benefits all energy consumers receiving the discounted rate, even those that do not require assistance. Further, as discussed above, setting prices at artificially low levels prevents price signals being used to create a more efficient energy system in general.

The Association considers that a superior approach is to decouple social welfare outcomes from energy prices. This approach has two general steps. Firstly, energy prices should be at the 'right' level i.e. a price that reflects the prevailing supply and demand conditions, noting that, as per Theme 2, this may in due course include time of use signals.

Then secondly, to the extent that the 'right' prices that emerge from the operation of the market are considered beyond the capacity of certain consumers to pay, such consumers should be supported by purposely designed, budget funded measures. In addition, there may be other cost-effective ex-market options to support such households, such as supporting energy efficiency in social housing (Item 10).

Such a two-step approach is consistent with esaa's 8<sup>th</sup> Efficient Energy Market principle i.e. where the market is not appropriately delivering the community's social objectives, the government should explicitly describe and directly fund separate measures. This philosophy to approaching social welfare and energy policy is reflected in options and actions in Theme 6 and these are broadly supported by the Association, including proposals to improve the coordination, efficiency and cost-effectiveness of concessions and hardship assistance programs (Items 7 and 8) as part of the decoupling of social welfare tools from energy prices. The Association encourages the Government to clearly reaffirm this two step approach in the final *Energy2031*.

However, with respect to Item 1<sup>2</sup>, the Association considers that developing a tariff that simultaneously meets all these objectives may prove impractical. For instance,

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<sup>2</sup> "Develop and introduce a residential electricity retail tariff structure that is non-regressive, equitable and efficient, and which provides appropriate price signals to customers concerning the cost of their decisions on power use, particularly to customers using large amounts of power and customers using peak-period power"

there may be tensions between an efficient tariff that reflects the cost of energy supply and stakeholders' views of an equitable outcome e.g. such a tariff may result in a lower income household that consumes significant amounts of energy having an unmanageably large bill. The Association reiterates its view that efficiency and equity objectives should not be simultaneously pursued through tariffs and considers that reforms to tariffs are better addressed under the other themes in the final Strategic Energy Initiative.