



20 May 2011

By email: submissions@aemc.gov.au

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**Strategic Priorities for Energy Market Development -
Submission from Jemena Limited to the Australian Energy Market Commission**

Jemena welcomes the opportunity to make this submission on the AEMC's Strategic Priorities discussion paper. We also appreciate the extension of time made available for us to complete the submission.

Jemena looks forward to further consultation on this matter. If you wish to discuss the submission please contact Sandra Gamble on (02) 9455 1512 or at sandra.gamble@jemena.com.au

Yours sincerely

A handwritten signature in black ink that reads "Sandra Gamble".

Sandra Gamble
General Manager Regulation and Strategy
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Attachment:

Strategic Priorities for Energy Market Development: *Submission from Jemena Limited to the Australian Energy Market Commission, 20 May 2011.*



Strategic Priorities for Energy Market Development

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the Australian Energy Market
Commission**

20 May 2011





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Table of contents

1	Background to Jemena	2
2	Key messages	3
2.1	Purpose of AEMC consultation	5
2.2	AEMC strategic priorities	5
3	Strategic priority one – “A predictable regulatory and market environment for rewarding economically efficient investment”	7
3.1	Stable policy settings for network regulation	7
3.2	Why stability is needed	7
3.3	Recent challenges to stable policy settings	8
3.3.1	<i>Rising prices and community concern</i>	8
3.3.2	<i>Evidence for soundness of current policy settings</i>	10
3.3.3	<i>Merits review</i>	12
3.3.4	<i>Jemena conclusion on stable policy settings</i>	13
4	Strategic priority two – “Building the capability and capturing the value of flexible demand”	15
4.1	Stage three of AEMC review.....	15
4.2	What does efficient demand response mean?	15
4.3	Demand side response – the role of distributors	16
4.4	Other demand side measures.....	17
5	Strategic priority three – “Ensuring the transmission framework delivers efficient and timely investment”	18

1 Background to Jemena

Jemena directly owns Jemena Gas Networks (NSW) Ltd (the major NSW gas distribution network) and Jemena Electricity Networks (Vic) Ltd in Victoria. Jemena partially owns the United Energy Distribution electricity distribution business in Victoria (34%) and the ActewAGL gas and electricity distribution business in the ACT (50%). Additionally, Jemena owns two major gas transmission pipelines.

Jemena provides widespread services to a range of gas and electricity assets in Australia. Overall, Jemena manages \$8 billion worth of gas and electricity assets.

2 Key messages


2.1 Jemena conclusions on Strategic Priority One – A predictable regulatory and market environment

Based on the substantial issues raised in this submission, Jemena concludes that:

- There is considerable risk in advocating major changes to the framework for the economic regulation of energy networks at this time, especially as calls for change come as hasty and unsupported reactions to recent price adjustments.
- Another wide ranging framework review so soon after the last one would likely create major uncertainty for network owners and providers of investor funds.
- The current policy settings—as embodied in the current national electricity and gas laws and rules—are working well in terms of delivering transparency, accountability and economic integrity of the regulation of energy networks.
- There may be opportunities now for rule changes to enhance the application of the current policy and clarify interpretation of the rules, or to improve the statutory processes for the next round of regulatory reviews. We anticipate that these will be the nature of changes the AER will bring forward.
- The AEMC’s consideration of a rule change proposal from the AER or any other party should be a matter of business-as-usual for the AEMC rather than a strategic priority.

2.2 Jemena conclusions on Strategic Priority Two - Capturing the value of flexible demand

- Jemena recognises that growing peak demand capacity in line with increased consumer peak demand usage will come at a high eventual cost to consumers.
- Jemena submits that correct peak time pricing signals to consumers are the key to efficient and effective consumer responses.
- Tariff reform, allied with appropriate metering technology and carefully targeted information for consumers, are the tools to deliver effective consumer responses at peak demand times.
- While it will be important for the Stage 3 Demand Side Participation review to consider the role of demand side participation under our current market



conditions, it would be worth thinking about what lies ahead and how to leave room for market innovations and evolution.

3 Introduction

3.1 Purpose of AEMC consultation

In his Introduction to the Strategic Priorities paper (the paper), the Chairman of the AEMC has said:

“We are looking to develop a well-informed debate on what really matters in terms of priorities for market design and the delivery of affordable, reliable and secure energy for the whole community. As consensus builds around those priorities for market development work in the Australian energy sector we will structure our work programme to help address those priorities.”¹

Jemena welcomes this debate, and considers it very timely in view of the many challenges facing the Australian energy market – both those identified in the paper and others of equal magnitude.

3.2 AEMC strategic priorities

The paper identifies three strategic priorities that will help the AEMC to address emerging challenges:


- a predictable regulatory and market environment for rewarding economically efficient investment
- building the capability and capturing the value of flexible demand;
- ensuring the transmission framework delivers efficient and timely investment.

Jemena welcomes the AEMC’s endeavour to identify the priorities that will shape its future work program, and its willingness to provide stakeholders with an opportunity to help shape those priorities through this consultation process.

By establishing the right priorities, the AEMC will ensure that it, industry and other stakeholders are focussing the most critical challenges with a clear understanding of the context and complexity of the market. It will also ensure that the AEMC initiates change where it is needed, while preserving an appropriate level of stability. The right balance between change and stability is important for the energy industry which is highly capital intensive and subject to strong pressures - not the least of which arise from its regulatory environment - as well as pressures from many other directions.

The AEMC is right to say that an expectation or perception that the implementation of policy settings will be regularly changed in the future can create uncertainty and

¹ AEMC, *Strategic Priorities for Energy Market Development Discussion Paper*, 1 April 2011, p. 1.



cause additional costs.² Such uncertainty and costs inevitably lead to inefficient outcomes.

Additionally, it is important that the Federal Minister for Resources and Energy has indicated that the AEMC's strategic priorities will provide the Government with valuable background information for formulating policies for the energy market, including future reforms.

Accordingly, Jemena will welcome the AEMC's careful consideration and analysis of stakeholder views, and confirmation of its proposed work program in its final priorities document. We can then get down to the job.

We comment on the AEMC paper in more detail in the following sections.

² AEMC, *Strategic Priorities for Energy Market Development Discussion Paper*, 1 April 2011, p. 7.



4 Strategic priority one – “A predictable regulatory and market environment for rewarding economically efficient investment”

4.1 Stable policy settings for network regulation

Jemena considers that a predictable regulatory and market environment is critical to the efficient operation of the energy market, and welcomes the AEMC’s recognition of this need.

Jemena also welcomes the acknowledgement by the Minister for Resources and Energy at the launch of the AEMC paper that:

Getting the “right” level of network investment is extraordinarily complex. There is always a balance between maintaining reliability and cost to the community.

We elaborate on this message below.

4.2 Why stability is needed

The AEMC paper puts the view that the impact of policy uncertainty on investment decisions will be greater in the competitive generation and retail sectors than in the monopoly network sectors.³


Jemena believes that the above view could potentially create the unintended, and incorrect, impression that the network sector is not also highly sensitive to policy uncertainty. The ability of network businesses to access equity and debt and their associated costs are strongly and directly linked to the view of investors and institutions that our regulatory environment is stable and provides revenue certainty for period well in excess of the five year regulatory cycle. Any change to that view will drive up our cost of capital and, consequently, prices to customers.

Jemena agrees with the following points made by the Energy Supply Association of Australia (**esaa**) in its recent response to the Garnaut Climate Change Review Update:⁴

Australia will need to attract overseas debt and equity as well as domestic investment if it is to find the capital to meet its [energy] investment task; the sector is internationally exposed in this regard

³ AEMC, op.cit., p.7.

⁴ ESAA submission, *Garnaut Climate Change Review – Update 2011, Paper 8: Transforming the Electricity Sector*, 19 April 2011, p.7.



Australia consequently must take steps to ensure it presents as an attractive destination if it is to raise this capital in the volumes required and at the lowest possible cost.

Jemena observes that networks are no different from other parts of the energy supply chain in requiring policy certainty to fund ongoing investment.

Although networks are capital intensive, investors accept that networks earn low-risk rates of return. The trade-off for this modest return is investor certainty about the ongoing stability of the regulatory frameworks. While the exact rates of return available to networks in future regulatory periods may be unknown, the expectation that the frameworks will not be constantly reworked in response to short term community and political concerns provides much-needed investor confidence.

Jemena welcomed the major reforms to energy market institutions and to the national electricity and gas laws and rules a few years ago. Overall, these reforms represented a major step change and considerable improvement in the transparency, accountability and economic integrity of the regulation of energy networks. While there may be an opportunity to make incremental improvements to the rules—to clarify them or create more effective statutory processes—the underlying policies remain sufficiently sound for the regulatory framework to remain largely unchanged at this time.

4.3 Recent challenges to stable policy settings

4.3.1 Rising prices and community concern

It is true that network charges, particularly in some states, have had to rise recently at a significant rate (and will have to further increase) in order to undertake necessary expenditure on replacement, upgrade and augmentation. This has contributed to well-publicised consumer electricity price increases, followed by media, political and consumer reaction.

While the AEMC has been a part of the process that has brought about the current electricity and gas law and rules, it is clear that the majority of commentators outside the energy sector—and small consumers—have not had the benefit of being part of that conversation. Eliciting an informed debate on rising prices now, engendering a common view of the drivers, especially with the prospect of a carbon price, is not an easy task.

Jemena encourages the AEMC to continue to take a measured approach as to how it sets its strategic priorities, and to resist unsupported calls for a broad review of the rules relating to network regulation beyond its consideration of the AER's expected rule change proposal.

In particular, over recent weeks, two public reports have called for changes to network policy settings:

- the Garnaut Climate Change Review Update: *Paper 8 – Transforming the Electricity Sector*
- the Independent Pricing and Regulatory Tribunal (**IPART**) draft report: *Changes in regulated electricity retail prices from 1 July 2011*, April 2011.

Both reports express concern about rising energy prices and, without detailed analysis, draw a number unsupported of conclusions about the adequacy of current network regulation and infer that its major features are biased against consumers. IPART recommends that:

The Australian Energy Market Commission (AEMC) initiate a review of the NER to ensure the rules do not bias the Australian Energy Regulator's decisions in favour of higher network prices and inefficient outcomes.⁵

Further, IPART's own commentary highlights that increasing network charges are not the only significant driver of consumer prices. IPART has indicated that of the average 18% consumer price increases from 1 July 2011, only 10% (or 55%) is network related.⁶ The rest comes from government policy in the form of imposed renewable energy targets, statutory reliability standards, and some minor generation and retail components.

Jemena supports submissions that the Energy Networks Association (**ENA**) and esaa have made to Professor Garnaut and IPART in which they have highlighted that there is no need for a major revision to existing regulatory frameworks, and the costs associated with creating unnecessary uncertainty about the stability of the framework.

The ENA has submitted carefully considered responses to each of IPART's recommendations and concludes⁷:

- the draft IPART report does not consider the full range of regulatory and public policy considerations which produced the current National Electricity Rules and associated legislative framework, including substantial AEMC input
- it follows from this, and from the MCE's key policy goals for energy market reforms, that the network sector does not accept that a review of current regulatory arrangements in the areas outlined by IPART is warranted.

⁵ IPART, op. cit., p. 82.

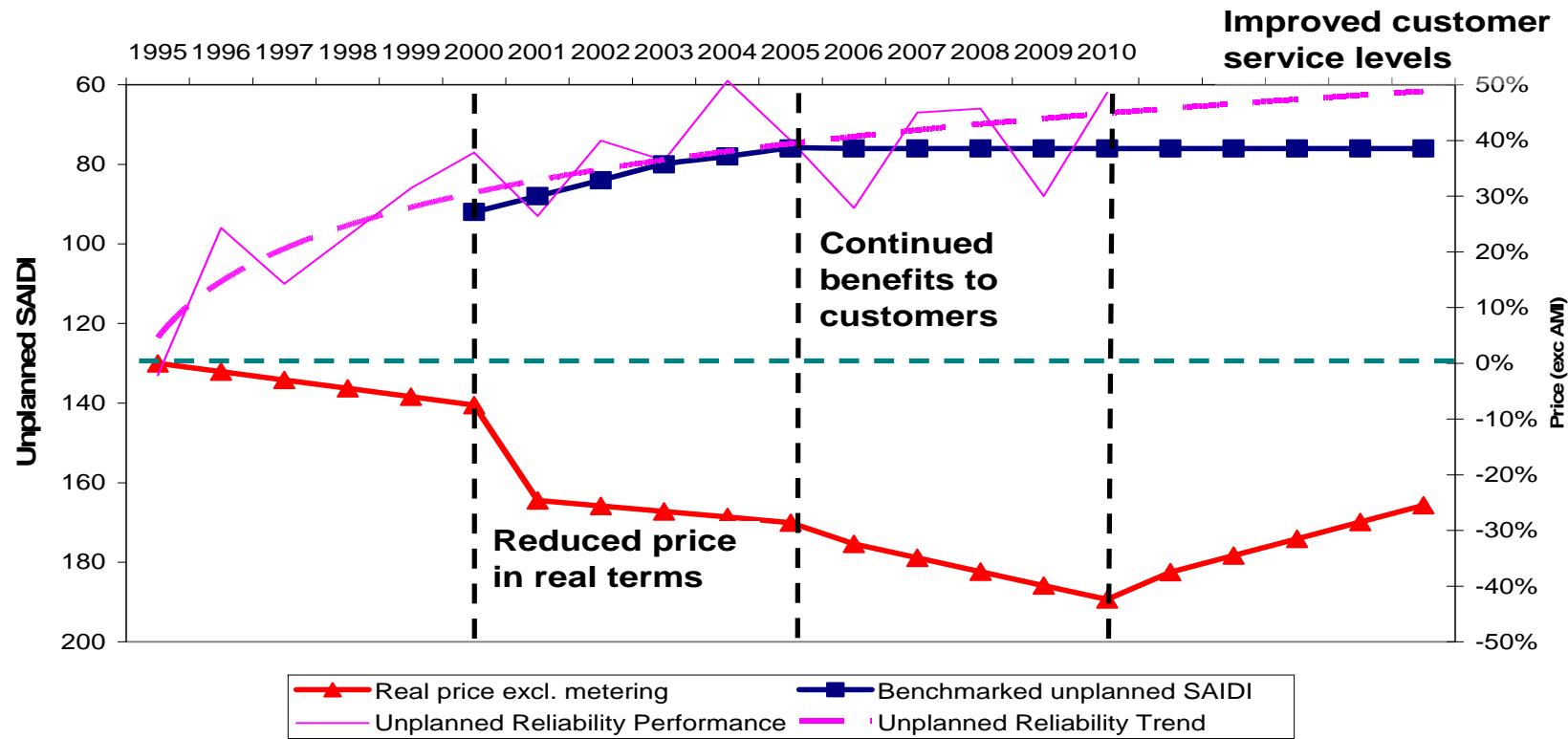
⁶ Rod Sims, Chairman IPART: *Regulated retail electricity prices from 1 July 2011*, 29 April 2011.

⁷ ENA, *Response to NSW Independent Pricing and Regulatory Tribunal—Draft report—Changes in regulated electricity retail prices from 1 July 2011*, 12 May 2011, p.3.

4.3.2 *Evidence for soundness of current policy settings*

Jemena submits that the current regulatory settings are working effectively in assisting the delivery of cost efficient network services, whilst delivering high levels of reliability. Figure 1 (next page) highlights the Jemena Electricity Network (JEN) actual and forecast reliability and network pricing, excluding metering charges, since 1995. Customer reliability has improved significantly over this period, while real network tariffs paid by residential customers have decreased by approximately 25%. Rising prices from 2010 onwards are primarily driven by the need to replace a significant portion of foundation assets constructed in the 1950s and 1960s.

Figure 1 – JEN price-service offering for residential customers



4.3.3 *Merits review*

The AEMC has indicated that the role of merits review is another potential area of review.⁸ One of the persistent themes in both the Garnaut and IPART reports (and from other commentators) is that the appeals process (merit reviews) are a one way option for network businesses to increase prices. Consequently, there are calls for a Government review of the merits review process.

Should the MCE determine that the AEMC is an appropriate body to consider the role of merits review, and the AEMC considers it for inclusion as one of its strategic priorities, we again encourage the AEMC to consider the need to preserve the integrity and stability of the regulatory institutions and frameworks.

The ENA correctly observes that⁹:

The appeal process under the National Electricity Law is a form of limited merits review which like other administrative and judicial appeal mechanisms focuses on the issues in dispute between the two parties. This is the result of a deliberate policy decision taken by the Ministerial Council on Energy to establish a form of review that was timely, efficient, and focused on improving the quality of primary regulatory decision-making and correcting regulatory errors.

The ENA also observes that:¹⁰

IPART suggests that the current appeals arrangements lead network businesses not being required to consider the whether they could end up 'worse off' as a result of lodging a review. This proposition is incorrect. The decision to undertake an appeal under the current framework needs to take account of substantial potential risks and costs.

Contrary to IPART's assertion, a network business does face the real prospect of adverse outcomes from lodging a review through the capacity of a range of parties and interveners to raise additional review matters. This creates the potential for other wider elements of the decision to be opened for review, to the potential material disadvantage of the network business. In addition, Ministers of participating jurisdictions may intervene without leave.

Jemena agrees with these assessments. The AER has the potential to make decisions that are not in the long term interests of consumers if these decisions unduly penalise businesses. It is through a focused merits review process that this adverse outcome can be discovered and corrected.

The experience of merits review for businesses is often misconstrued. To clarify this we make the following points from our own experiences:

⁸ AEMC, *Strategic Priorities for Energy Market Development Discussion Paper*, 1 April 2011, p. 49.

⁹ ENA, *op.cit.*, p. 8.

¹⁰ *Ibid.*

- a decision to initiate a merits review is not an easy or automatic one because it brings material new costs and risks
- merits review gives no guarantee of a successful outcome for a regulated business because, to be successful, the appellant must persuade the Australian Competition Tribunal (an independent expert body) that the AER has made a substantial error
- the AER has broad discretions to make its decision and showing error is complex and difficult
- even when an error is established, a merits review opens the prospect of a more adverse decision for the network business.

Jemena notes that the Productivity Commission has, in several investigations, endorsed the value of merits review as an integral part of economic regulation. Its latest comments are:

The potential for merit review is important both for safeguarding the rights of those regulated and for ensuring regulators follow due process in making their decisions. An independent review of the reasons for, and the processes used to arrive at, decisions can help in the identification and improvement of ineffective regulation. It can also highlight any insufficient reasoning or misuse of power on the part of the regulator. Moreover, the possibility of regulatory decisions being reviewed at a later stage encourages regulators to follow due process.¹¹


Accordingly, no clear case has been established for the AEMC to include a review of the role of merits review in its strategy priorities.

4.3.4 *Jemena conclusion on stable policy settings*

Given the substantial issues raised in the preceding sections, Jemena therefore submits:

- There is considerable risk in advocating major changes to the framework for the economic regulation of energy networks at this time, especially as calls for change come as hasty and unsupported reactions to recent price adjustments.
- Another wide ranging review so soon after the last one would likely create major uncertainty for network owners and providers of investor funds.
- The current policy settings—as embodied in the current national electricity and gas laws and rules—are working well in terms of delivering

¹¹ Productivity Commission, *Australia's Urban Water Sector - Draft Report*, April 2011, p.290.



transparency, accountability and economic integrity of the regulation of energy networks.

- There may be opportunities now for rule changes to enhance the application of the current policy and clarify interpretation of the rules, or to improve the statutory processes for the next round of regulatory reviews. We anticipate that these will be the nature of changes the AER will bring forward.
- The AEMC's consideration of a rule change proposal from the AER or any other party would be a matter of business-as-usual for the AEMC rather than a strategic priority.

5 Strategic priority two – “Building the capability and capturing the value of flexible demand”

5.1 Stage three of AEMC review

Jemena notes that the MCE has recently initiated stage 3 of the Demand Side Participation (DSP) review.

The AEMC has described the scope of the review as:

The AEMC DSP stage 2 Review was undertaken with an explicit focus on the National Electricity Rules to determine whether there were material barriers to the efficient and effective use of DSP in the NEM.

The Stage 3 DSP Review will have a broader focus beyond the Rules. It will include all arrangements that impact on the electricity market supply chain.¹²

Jemena looks forward to engaging with AEMC on the stage 3 review. It will be valuable to determine if there are significant remaining barriers to DSP and how these might be addressed in a least distortionary way.

5.2 What does efficient demand response mean?

In relation to its strategic priority two, the AEMC paper says:


The second priority we are seeking views on relates to how consumers participate in the market, including offering demand reduction into the market and take-up of energy efficiency technologies. This strategic priority has the potential to mitigate the impact of rising prices for consumers, and to increase market resilience, particularly if more demand side participation is available at times of high demand. It also recognises the potential that energy markets will move from supplying gas and electricity as commodities to providing a broader range of energy services.¹³

Jemena recognises that growing peak demand capacity in line with increased consumer peak demand usage will come at a high eventual cost to consumers.

The issues from Jemena’s network perspective are therefore:

¹² <http://www.aemc.gov.au/Market-Reviews/Open/Stage-3-Demand-Side-Participation-Review-Facilitating-consumer-choices-and-energy-efficiency.html>

¹³ AEMC, op.cit., p.39.

- 
- What are the best ways to communicate the real costs of peak demand electricity to consumers?
 - What should be expected from networks in facilitating consumer responses to the underlying costs of electricity supply?

The ESAA has made some pertinent observations on these issues to the Garnaut Update¹⁴:

At present, many consumers, in particular households, receive no price signals that tell them when the network is at or near its capacity, and so they have no incentive to do what they can to shift demand away from these peaks. Several distribution businesses have trialled pricing systems that seek to address this, but political and community opposition inhibit more widespread application. Other potential methods, including ways to (with customers' permission) directly control their demand levels at peak times without reducing overall amenity are also being trialled, but both pricing and direct control approaches require investment in new technologies. These technologies along with other tools to more effectively manage the distribution system are collectively termed the "smart network", and the Update rightly notes the potential value of this suite of technologies.

Jemena endorses the view that correct price signalling is essential to promoting efficient demand response by consumers, and elaborates on this view below.

5.3 Demand side response – the role of distributors


While demand side participation in the broad sense covers many subsidiary issues, Jemena submits that correct peak time pricing signals to consumers are the key to efficient and effective consumer responses. Jemena submits that tariff reform, allied with appropriate metering technology and carefully targeted information for consumers, are the tools to deliver effective consumer responses at peak demand times.

The AEMC paper notes:

Without appropriate technical, technical, contractual and regulatory arrangements, the potential benefits of [smart] meters may not be harnessed. Consumers will need to be given the information and tools to make use of the information and capabilities provided by smart meters. Smart meters are not an end in themselves, but a means to facilitate a range of measures that will allow customers to be more flexible in their demand patterns.¹⁵

¹⁴ ESAA, op. cit., p. 9.

¹⁵ AEMC, op.cit., p.41.



Jemena welcomes the AEMC paper's recognition of the potential role of metering technology, and that it needs to be supported by accommodating contractual and regulatory arrangements to allow its benefits to be realised.

Over the longer term, energy network businesses will need to be alive to the significant changes occurring in their markets, such as new entrants, products and services. Their business strategies will need to adapt to change as new commercial pressures are brought to bear. The interplay between efficient network investment, product offerings, pricing, customer response, new forms of competition, and the role of economic regulation will become increasingly complex and dynamic.

While it will be important for the Stage 3 DSP review to consider the role of demand side participation under our current market conditions, it would be worth thinking about what lies ahead and how to leave room for market innovations and evolution.

5.4 Other demand side measures

Jemena is supportive of using other measures to encourage efficient energy consumption, such as well designed energy efficiency and greenhouse gas emissions policies.

However, Jemena submits that these measures must be cost efficient, evidence-based and be complementary to, but operate outside of, the regulatory and market frameworks. Jemena submits that it is not the role of the network regulatory frameworks to be a conduit of energy efficiency schemes or social policy objectives.

There may be value in the AEMC, along with market participants, making an assessment of whether these externally driven policies are either complementary or unacceptably distortionary (on a case by case basis). Jemena notes that the necessary mechanisms for an AEMC investigation of any proposed policies are already in place to ensure that these issues are dealt with at the appropriate time.



6 Strategic priority three – “Ensuring the transmission framework delivers efficient and timely investment”

Jemena notes the importance of the transmission sector in the NEM and that sufficient investment must be forthcoming to allow transmitters to provide a reliable and cost effective transmission service.

Jemena notes that the AEMC is already undertaking significant work on transmission frameworks, most notably through the Transmission Frameworks Review, and supports the AEMC continuing this work to its final conclusions and recommendations.

Consistent with our views in section 4 above on stable regulatory frameworks and policy settings, once the current review and related rule changes are complete, the framework should not be revisited for several years.



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