



Economic Regulation Authority

 WESTERN AUSTRALIA

Level 6, Governor Stirling Tower  
197 St Georges Terrace  
Perth Western Australia 6000

GPO Box 8469  
Perth Business Centre  
Western Australia 6849

Telephone 61 8 9213 1900  
Facsimile 61 8 9213 1999  
Website [www.era.wa.gov.au](http://www.era.wa.gov.au)

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Your Ref:

Our Ref:

15 April 2010

Andrew MacFaul  
Consultation Co-ordinator  
Office of Gas and Electricity Markets  
9 Millbank  
LONDON  
SW1P 3GE

Dear Mr MacFaul

## **OPTIONS FOR DELIVERING SECURE AND SUSTAINABLE ENERGY SUPPLIES**

The Economic Regulation Authority (Authority) welcomes the opportunity to respond to Ofgem's call for submissions on Project Discovery; Options for Delivering Secure and Sustainable Energy Supplies.

The Authority is Western Australia's independent economic regulator. It licenses providers of gas, electricity and water services and regulates economic aspects of the gas, electricity and rail industries in the State. The Authority functions to maintain a competitive, efficient and fair commercial environment, particularly where businesses operate as natural monopolies, for the benefit of the Western Australian community. The Authority also inquires into matters referred by the State Government. It is independent of industry, government, and other interests and is not subject to State or Ministerial direction in carrying out its regulatory or inquiry functions.

The Authority offers this submission to contribute and further the debate in economic regulation.

### **Overview**

Of particular note in the consultation paper is the observation that the electricity and gas markets in Great Britain have performed reasonably well against two main objectives as set out on page 14 of the paper. These two objectives place emphasis on efficiency, cost effectiveness and timeliness, which are well served by a properly performing market.

It therefore comes as a surprise that Ofgem sees the need for making changes to current arrangements that go beyond enhancing the operation of the market. Indeed, one of the scenarios considered involves supplanting market arrangements by centralised coordination while another involves centralised procurement.

While one of the options calls for the short term price signals to be improved so that in times of system stress supply and demand will be guided toward an efficient outcome, the consultation paper does not canvass options that provide for a more comprehensive role for price in the market. For example, Ofgem might wish to consider the National Electricity Market of Australia as an example of a market design that provides price information, with associated derivative markets and resultant investment, in a more transparent way than does the market design in Great Britain.

In addition, the selected scenarios appear to address objectives other than those referred to on page 14 of the paper. The paper gives the impression that Project Discovery places greater weight on a range of other objectives such as securing sustainable energy supplies at lowest cost as distinct from achieving efficient, cost-effective and timely outcomes.

Lack of clarity as to the objectives and, uncertainty about market design, and the threat of centralised coordination and procurement create real risks for market participants with self-fulfilling consequences raising the prospect that centralised procurement or tenders for capacity becomes inevitable. Interestingly, in part, this point is recognised in paragraph 3.14 which attributes a substantial wave of external investment in Great Britain's energy market since liberalisation to "...the high degree of transparency in the GB market and the perception that the risks of government and regulatory intervention were low". With the focus on centralised intervention, there is a risk that Project Discovery will discourage external investment in Great Britain's energy market leaving centralised intervention as an inevitable outcome.

Placing particular weight on specific objectives such as securing sustainable energy supplies by centralised intervention is destined to produce unsatisfactory outcomes. Rather, a well functioning market incentivises participants to make their own assessment of the commercial risks involved, be innovative and adapt to future circumstances.

While the paper identifies many, if not most, of the problems associated with centralised intervention, there nonetheless seems to be a lack of concern about associated unintended consequences. The effect of centralised intervention is to re-arrange incentives which may see increased investment in some areas and reduced investment in others. While some of the effects will be desirable others will not. On balance, however, centralised intervention introduces distortions that have a negative impact on economic performance and on the long-term interests of consumers.

The problem of unintended consequences is closely aligned to an underlying view, implicit in the paper, that centralised intervention can deliver on objectives such as securing sustainable energy supplies at lowest cost, achieving cuts in carbon emission levels and achieving renewables targets without compromising the long-term interests of consumers. Intervention in markets does not offer a free lunch but shifts the focus from efficient, cost-effective and timely outcomes toward higher overall costs and less efficient outcomes for consumers in the long term.

## **PARTICULAR ISSUES**

### **Financing**

It is noted that project discovery estimates that up to £200 billion of investment might be required by 2020. The paper indicates that this investment is needed to replace ageing infrastructure, meet new challenges including the decline in Great Britain's indigenous gas supplies and achieve the Government's renewable energy target.<sup>1</sup> In suggesting that

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<sup>1</sup> Paragraph 2.1 Project Discovery Paper Ref: 16/10 February 2010.

expectations of growing demand may not prevail into the future<sup>2</sup>, the likelihood is that the increase in required investment will need to be spread over existing demand with understandable upward pressure on prices. However, it should be recognised that investment to replace aging infrastructure is already embedded in prices since service providers will have built depreciation of existing plant into prices. The problem associated with replacing aging plant is therefore not so much in the nature of a funding problem as it is a financing problem. In effect, service providers may choose to re-invest available funds in other areas of the economy or in other countries depending on available returns. The availability of better returns in other areas of the economy or in other countries is not a basis for centralised intervention as this can only lead to reductions in economic performance.

A related issue is that the financing of investment in the energy market is more of an issue for the capital market than the energy market. Failures of the capital market, such as that brought about by the global financial crisis, are matters best resolved by enhancing performance of the capital market as opposed to intervention in the energy market.

### **Investment Signals in Generation**

Western Australia is a relative newcomer to operating an electricity market, the electricity trading component of which commenced operation on 21 September 2006. For reasons that the State is seriously isolated and not connected to the national grid that operates along the eastern and south eastern seaboard of Australia, the State opted for a market structure comprising a bi-lateral energy market, a capacity market involving a capacity credits mechanism, a one day ahead short-term electricity market and a balancing market. Although this market has performed well, there are good grounds for, over time, moving toward a more liberalised arrangement. The existing arrangements are administratively complex and costly. As might be expected, there are a range of teething problems that will take time to resolve. Nonetheless, indications are that further liberalisation is warranted and the Authority has recommended to Government the development of a road map for the further evolution of the Western Australian wholesale electricity market.<sup>3</sup>

### **Risk Management**

In June 2008, Western Australia experienced a major and protracted disruption to its gas supply following an explosion at a production/processing plant located at Varanus Island off the north-west coast of Australia. The loss of supply represented approximately 30 per cent of the State's total supply. One of the important features of this event was that it caught many gas users including retailers by surprise in that they did not appreciate the precarious nature of gas supply, particularly from a source supplying gas at very competitive prices.<sup>4</sup>

To its credit, the Government did not give in to the temptation of declaring a fuel supply emergency but established a make shift bulletin board and otherwise assisted market participants to commercially trade out of their supply problems.

An important lesson from the Varanus Island supply disruption was that market participants were clearly reminded of the risk of supply disruptions and that the onus was on them, and not government, to insure against fuel supply emergencies through fuel supply diversification, alternate energy sources and storage.

### **CONCLUSION**

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<sup>2</sup> Ibid paragraph 3.6

<sup>4</sup> <http://www.abc.net.au/news/stories/2008/10/10/2387819.htm>

Recognising the lead role that Project Discovery may play, not just in relation to Great Britain but in relation to other parts of the world, it is considered that the project would be likely to benefit from additional work by undertaking:

- an assessment of possible unintended consequences associated with centralised intervention and the cost of such unintended consequences where centralised intervention is proposed;
- the development of a scenario or scenarios that seek to address future challenges through enhancement of the market as opposed to centralised intervention;
- an assessment of the risk that proposed centralised intervention will prove to be unnecessary in relation to the various scenarios where centralised intervention is proposed; and
- an assessment of the total cost of intervention if centralised intervention proves to be unnecessary.

Hopefully the above comments will be helpful and I thank you again for the opportunity to respond to Project Discovery.

Yours sincerely

A handwritten signature in black ink, appearing to read 'L Rowe', with a stylized, cursive script.

LYNDON ROWE  
**CHAIRMAN**