

POWER PLAYS

The State of the energy market 2007 report covers the electricity wholesale and forward markets, gas markets, energy networks and the energy retail sector.

THE AUSTRALIAN energy sector has been transformed over the past 15 years to a competitive, nationally focused market. Regulatory barriers to interstate trade are gone, third party access to the networks has been introduced and the old public monopolies have been split up.

This transformation and other changes are outlined in a landmark new report issued by the Australian Energy Regulator (AER).

The 320-page *State of the energy market 2007* report covers the electricity wholesale and forward markets, gas markets, energy networks and the energy retail sector.

The report highlights how changes have allowed competitive energy markets to develop. As a result of the establishment of the national electricity market in the Eastern States, power can now flow across state borders to meet demand more efficiently. Liberalised energy markets have also led to substantial new investment. Annual investment is running at around \$700 million in high-voltage electricity transmission infrastructure and \$3 billion in the local distribution networks that move electricity to customers. Over the long term the market has delivered stable reliability, improved productivity and—until very recently—significantly lower energy costs.

Transition to national regulation

A central focus of energy policy reform in the past three or four years has been the development of a national regulatory framework. In 2005 governments established two national bodies—the AER and the Australian Energy Markets Commission. The underlying principle was that a national energy market needs a consistent national approach, rather than a state-by-state-approach to regulation.

The AER will assume responsibility for the economic regulation of the national electricity market energy sector on a staged basis over the next two years. It has been the regulator of the wholesale market and transmission networks in that market since July 2005. The regulation of electricity distribution networks, gas pipelines and some retail functions will transfer from the states to the AER over the next six to 18 months.

Recent energy market activity

The AER monitors the compliance of market participants, according to the National Electricity Law and the National Electricity Rules; and investigates and prosecutes breaches. Due to unusually volatile conditions, the AER has closely monitored the wholesale electricity market in 2007. Wholesale prices rose sharply in autumn because the



drought constrained hydro-generating capacity in the Snowy region, Tasmania and Victoria. The drought has also limited the availability of water for cooling in some coal-fired generators, especially in Queensland.

These tight supply conditions were exacerbated in June 2007 by rain and flooding in the Hunter Valley. Cold winter days also increased heating requirements, leading to record electricity demand. These factors led to an extremely tight supply-demand balance during the early evening peak hours, particularly in New South Wales. The practice of day-ahead bidding by generators, particularly Macquarie Generation, also aggravated the situation. Macquarie Generation repriced capacity into higher price bands during evening peaks throughout June.

In combination, these conditions led to some of the highest spot prices since the national electricity market commenced.

High prices flowed through to the forward market for electricity derivatives, which also experienced record prices in June. This put pressure on retailers and large energy users that needed to refinance their energy contracts. As a result, Energy One withdrew from the market and initiated the retailer-of-last-resort scheme, while Momentum

Energy divested most of its small customer contracts. This shake-out has reduced the number of independent retailers and may weaken competitive pressures in the market.

While electricity prices have eased towards more normal levels since June, there are risks that high prices may return in the future unless new investment increases capacity. There has been some response by investors in 2007. Origin Energy recently announced the construction of a 630-MW gas-fired power station in the Darling Downs region of Queensland for commercial operation in early 2010 and an expansion of its Quarantine gas plant in South Australia. These and other responses are positive indicators that price signals in the market are working.

There are nonetheless some concerns about ongoing investment. The Energy Reform Implementation Group's 2007 report to COAG referred to the risks associated with government-owned energy businesses and to evidence of intermittent but persistent market power in the NSW market. More recently, the NSW Owen inquiry has recommended the privatisation of government-owned assets in the electricity sector.

The *State of the energy market 2007* report is available on the AER website, www.aer.gov.au. ●