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Submission to the AEMC

Economic Regulation of Network Service Providers

Consultation on Request for Rule Change

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Total Environment Centre (TEC) welcomes the opportunity to provide comment as part of the rule change process regarding the economic regulation of Network Service Providers (NSPs). TEC has advocated for optimal demand-side participation (DSP), including the removal of supply side bias, in the National Electricity Market (NEM) since 2004.

TEC is of the opinion that the current regulatory framework of the NEM systemically favours the supply side and encourages greater capital expenditure on infrastructure (capex) at the expense of DSP solutions to meeting demand for electricity.

The weak economic regulation of NSPs is a significant part of this bias as it heavily favours NSPs and disadvantages the Australian Energy Regulator (AER), which has found it difficult to curtail excessive capex. This has resulted in increased prices for consumers beyond those necessary to achieve an efficient, safe and reliable electricity supply.

These rule change proposals seek to address this part of the supply-side bias in the NEM and TEC is therefore broadly supportive. More detailed comments based on our experience in the NEM are set out below.

1. AER Rule Change Request

a. The problem

TEC agrees with the issues identified by the AER in their rule change proposal. TEC has previously noted a number of these issues and has advocated changes to the rules, which these proposals seek to implement to some extent.

Specifically, TEC believes that:

- The capex and opex framework allows NSPs to recover costs and make profits beyond those that are reasonable and efficient;
- The current rules do not adequately safeguard against excessive revenue proposals from NSPs nor do they allocate the AER sufficient powers to curb such proposals;
- The requirements that the AER base revised forecasts for Distribution NSPs (DNSP) on the DNSPs original proposal, and that the AER only amend the proposal to the extent necessary for it to be within the broad bounds of acceptability under the National Electricity Rules (NER) are unduly restrictive;
- The requirement that all capital expenditure be rolled into the Regulated Asset Base (RAB) at the start of the each regulatory period encourages overspend, or, at the very least, does not encourage disciplined and efficient capex;
- The provisions of the NER regarding setting the Weighted Average Cost of Capital (WACC) place too much emphasis on precedent, rather than present market conditions and evidence, and the WACC settings have proven to be well above the true cost to regulated NSP businesses;
- Under the current rules, lengthy and complex revenue proposals and short timeframes ‘shut out’ consumer groups. NSPs have extensive resources and a long timeframe in which to compose their proposals, thus weighting the whole process in their favour;

- While not directly at issue in this proposal, the appeals process is also weighted in favour of NSPs, particularly when compared to those of other jurisdictions, such as the UK.

b. Prescription and discretion

TEC understands that there is a difficult balance that must be achieved between prescription and discretion. On the one hand, the rules must not be so prescriptive so as to preclude the AER from being flexible and adaptable to changing conditions, but at the same time, the rules must be prescriptive enough to ensure that NSPs have sufficient certainty and that there are sufficient pressures for NSPs to operate efficiently.

TEC generally agrees with the Chairman of the AER that the "rules that operate today are not only highly directive in regard to process, but limit the ability of the regulator to exercise a proper discretion in assessing key inputs to its decisions". TEC would generally advocate giving the AER broad flexibility in its decision-making.

The conflict between prescription and discretion is most acute in relation to the WACC element of this rule change and merits specific attention. This is addressed in more detail below.

c. AER's use of its discretion

TEC believes that the Regulator is the party best placed to assess its current position in the regulatory framework and provide the AEMC with evidence on the extent to which it uses its current discretion. The rule change proposal itself is symptomatic of the fact that the AER feels that it has not been given sufficient discretion and that it has not been able to effectively use the narrow discretion it is currently afforded by the NER.

TEC believes that the bias in the current framework may inhibit the AER from fully utilising its discretion. In particular, the appeals process whereby NSPs challenge the AER's revenue determinations has proven to be heavily weighted in favour of NSPs. A recent report by the Consumer Action Law Centre and the Consumer Utilities Advocacy Centre comprehensively analysed these issues. The appeals process allows NSPs to 'cherry-pick' elements of the AER's decision while not allowing elements of the decision favourable to the NSP to be reviewed. This has resulted in the overwhelming majority of appeals being successful.

This may act as a fetter on true and necessary discretion. To the extent that the AER can be alleged not to have utilised its existing discretionary powers, it may be that this reluctance is caused by the fact that their discretion is so easily and readily challenged by the NSPs.

d. The solution

TEC largely agrees with the AER's proposed changes to the rules and supports the amendments to the process for estimating the efficient level of capital required for safe and reliable provision of electricity.

In relation to the setting of the WACC, there are two rule changes that overlap to some extent. TEC has assessed the AER and Energy Users Committee (EUC) rule change proposals and would prefer the more prescriptive rule set out by the EUC.

While TEC agrees that the AER should be given greater discretion, and ability to use this discretion, in some areas, TEC is convinced by the EUC's arguments in favour of its rule change and agrees that the National Electricity Objective is better met by setting clear and fair rules for determining the WACC from the outset, rather than regular determinations by the AER.

Specifically TEC believes:

- The WACC is amenable to being defined by a rule from the outset as the conditions that shape the WACC are generally relatively stable; a well-drafted rule can ensure both certainty and flexibility from the outset;
- Determining the WACC on a periodic basis would:
    - add an unnecessary layer of complexity to the revenue setting process;
    - add a complex and technical matter to the workload of consumer advocates;
    - be another point of contention for NSPs, who would likely appeal the determinations, adding further cost and inefficiency;
- More concretely defining the WACC-setting process in the NER would ensure investment and planning certainty for NSPs;
- The evidence available suggests that, in this context, the AER has not used the discretion it does have effectively to date;
- The issue of state ownership is a critical one which is at the heart of energy market liberalisation and competition: this issue is not covered by the AER's proposal;
- TEC's own recent experience engaging with Powerlink's 2012-2017 revenue determination suggests that the AER is not sufficiently able to correct unrealistic WACC settings.

2. EUC Rule Change Request

a. Excessive profits to NSPs

TEC has consistently argued that the NER are systemically biased toward excessive NSP profits because profit is tied to capex. While other jurisdictions have moved away from this model, increasing capex still translates into greater profits for NSPs in the NEM. The WACC, which does not reflect the true cost of borrowing for NSPs, adds a windfall to already considerable NSP profits.

TEC recently made a detailed submission to the AER regarding Powerlink's revenue proposal for the next regulatory period. TEC conducted an in-depth analysis of Powerlink's proposal and noted that Powerlink's expenditure will increase by 97% over the next six years. TEC noted in the submission that Powerlink had used a range of creative accounting techniques to justify this excessive increase. Powerlink also focussed on drivers for expanding its capex, paying little or no attention to relevant factors reducing the need for increasing capex.

TEC understands that these excessive profits are not unique to Powerlink, but that NSPs generally are able to justify a high level of capex within the bounds of the current framework. This has clearly been the experience of the AER, while Ross Garnaut also highlights the role NSPs are playing in driving higher prices.

TEC is therefore firmly of the opinion that these profits are excessive, to the detriment of consumers, who pay more for their electricity, and the environment, as more infrastructure is built to transmit more electricity, increasing greenhouse gas emissions.

b. Government-owned NSPs vs. privately-owned NSPs

TEC believes that government-owned companies are able to leverage the states superior credit rating to obtain finance at a much more advantageous rate to privately owned NSPs, and commends the EUC's extensive and detailed analysis on this issue. TEC has previously noted that this is problematic, as have other commentators. TEC is in favour of this difference being accounted for in WACC determinations.

As mentioned above, TEC's own recent experience engaging with Powerlink's 2012-2017 revenue determination has led TEC to the conclusion that the WACC is set far too high for government-owned NSPs.

TEC would welcome input from state governments and NSPs as part of an inclusive process, but would advise the AEMC to approach such input cautiously, given the vested interests of these parties in maintaining any advantage that does exist. State governments reap large financial benefits from their ownership of NSPs and are likely to resist any changes that may undermine these benefits. While the AER is an independent regulator whose interest is to ensure the efficiency of the NEM in the interests of consumers and is therefore in a good position to speak on its own position, state owners and NSPs are not independent and are profit-driven, meaning that their input may not reflect the best interests of consumers, who are at the heart of the National Electricity Objective.

c. Competitive neutrality and capital market discipline issues

TEC does not see the imposition of differential rules as adversely affecting competitive neutrality. On the contrary, as government-owned NSPs benefit under the current rules, there is a strong argument that neutrality in fact requires that tailored rules be implemented to ensure that government-owned businesses compete on a level footing with those that are privately owned. The NER should provide substantive competitive neutrality between NSPs, rather than simply applying one rule to all NSPs regardless of factors that intrinsically affect competition between them.

The WACC rules must be altered to ensure that they truly reflect the cost of capital and that government-owned NSPs do not receive a windfall at the expense of privately-owned NSPs and, more importantly, consumers. Increased competition is one of the key drivers for privatisation, yet much of the benefit is lost if a state government retains ownership and extracts excessive profits at the expense of consumers.

NSP Response

TEC expects that NSPs will be universally against this rule change proposal, as it threatens their ability to make excessive profits. TEC is aware that NSPs have already made statements to the effect that the AER should better use the discretion it currently has and that no reforms are required.

TEC urges the AEMC to attach particular weight to the Regulator, energy users and consumer groups in the course of this rule change process. This rule change is driven by a need to better regulate networks in the interests of customers, and consumer advocacy groups have considerable experience and contact

with customers that are being affected by ever-rising electricity prices. Likewise energy user groups are well-placed to describe the impacts of the current rules on their members. Conversely, rising prices benefit NSPs and it can only be expected that NSPs and their representative groups will be opposed to this rule change.

Total Environment Centre strongly encourages the AEMC to adopt the proposed changes and address our concerns. We are grateful for the opportunity to contribute to the rule change process. Please do not hesitate to contact us if you require further information or clarification regarding the comments made in this submission.

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