

18 December 2014

Committee Secretary  
Standing Committee on Environment and  
Communication References Committee  
PO Box 6100  
Parliament House  
Canberra  
ACT, 2600



By electronic lodgment: [ec.sen@aph.gov.au](mailto:ec.sen@aph.gov.au)

Dear Committee

### **Inquiry Into The Performance And Management Of Electricity Network Companies**

Thank you for the opportunity to provide the *Energy User Association of Australia's (EUAA)* perspectives on the Senate Committee inquiry into the effectiveness of the regulation of Australia's electricity network businesses.

The EUAA represents many of the large energy users in Australia in the commercial, industrial and resources sectors. Our members account for a significant proportion of the energy consumed in Australia.

As you may be aware, this inquiry follows numerous recent reviews and inquiries into the effectiveness of energy network regulation, including the 2012 *Senate Select Committee on Electricity Prices* review.

The EUAA has provided detailed submissions to those previous reviews and has a sound understanding of the issues raised in this latest review.

This submission responds to the specific questions raised in the Inquiry Terms of Reference. It outlines the key deficiencies in the current regulatory framework for electricity networks and outlines reforms that need to be progressed to address those deficiencies, including key outstanding recommendations from previous expert reviews.

The EUAA is keen to engage with the Committee on the issues and recommendations raised within this submission.

Please do not hesitate to contact me should you require any clarifications or further information regarding this submission.

Yours Sincerely

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Chief Executive Officer  
Energy Users Association of Australia (EUAA)



# **Senate Inquiry into the Performance and Management of Electricity Network Companies**

18<sup>th</sup> December 2014

**Energy Users Association of Australia  
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## **EXECUTIVE SUMMARY OF KEY POINTS**

### **The Recent Regulatory Rule Changes**

The recent regulatory rule changes only involve some minor changes to the previous regulations. The key deficiencies of the regulatory regime that have driven the major unnecessary price increases still remain.

### **The Need to Optimise the Electricity Networks' Regulatory Asset Bases (RABs)**

Australia's electricity system now has an installed asset base well in excess of requirements.

The Regulated Asset Bases (RABs) - the valuation of the electricity networks' past investments, are grossly inflated due to unnecessary and inefficient investments, and a flawed asset valuation methodology.

Australian electricity consumers are already funding a significant level of "stranded assets".

The networks receive guaranteed returns on their past investments (RABs) - returns which are currently driving around 70% of their prices.

Whilst the recent regulatory rule changes have provided the AER with marginally more power to scrutinise future "gold plating", they do not allow the AER to address past gold plating.

To seriously address Australia's unsustainable electricity prices it is imperative that the networks' Regulated Asset Bases (RABs) are re-valued to more appropriate levels.

### **The AER's Approach to Determining Weighted Average Cost of Capital (WACC) Allowances**

The AER is providing cost of capital allowances to the electricity networks well in excess of their actual cost of capital.

The AER has consistently set higher WACCs than other comparable regulators.

Australia's electricity networks are far more profitable than the regulatory framework assumes.

Equity markets and investors are valuing network businesses significantly higher than their regulatory values.

Lenders are lending to the networks at significantly lower rates than their 'cost of debt' allowances.

The AER has inappropriately applied the discretion it has been provided under the new rules, by selecting WACC parameters at the top end of the possible ranges.

The AER must take account of the above 'evidence and market information', as required by the rules, to ensure that its WACC decisions achieve a better balance between the interests of the networks and consumers.

### **Government-Owned Networks**

The efficiency of Australia's electricity networks is predominantly determined by ownership.

The privately owned electricity networks in Victoria are much more efficient than the networks in the other states – demonstrating significantly lower growth in revenues, regulated asset bases, capital and operational expenditure per unit of output growth.

State government-owned electricity networks are achieving extraordinary profits – partly due to rules that require the AER to provide WACC allowances to government-owned networks as if they are privately owned.

In effect, the rules require the AER to ignore that government-owned networks are funded by low cost state government debt.

There is a very strong case for the privatisation of government-owned electricity networks, as recommended by the Productivity Commission.

It is important that any future sale or lease of government-owned networks eliminates ongoing funding from state treasury provided debt.

If the states continue to provide debt to electricity networks, then the regulatory rules need to be changed to enable the AER to determine WACC allowances that reflect the networks' actual cost of debt.

### **The Propose/Respond Revenue Determination Process**

Electricity networks take advantage of the information asymmetry and resource imbalance in the propose/respond process, resulting in the AER approving excessive and unnecessary expenditure.

The EUAA recommends that the 'propose/respond' revenue determination model should be replaced by the 'receive/determine' model that applied prior to 2006.

There is a need for further reforms to how the networks provide information to the AER – reforms that reduce the ability of the networks to take advantage of the inherent information and resource asymmetries.

### **Benchmarking**

In its Draft Determinations released in late November, the AER applied benchmarking to determine the opex allowances for the distribution networks - but not for the transmission networks.

The AER must apply benchmarking to determine efficient opex allowances for transmission networks.

### **Network Pricing**

The electricity networks' pricing methodologies are not cost reflective.

The AEMC draft determination on network pricing will not address the deficiencies in the networks' pricing methodologies - and will continue to provide the networks with too much discretion in price setting.

The rules regarding pricing methodologies need to be much more prescriptive and the AER needs to be provided with strengthened powers for assessing and approving those methodologies.

### **The Regulatory Rule Change Process**

Critical reforms to the regulatory framework are taking far too long. There is an urgent need to introduce an accelerated rule change process to deal with important rule changes in an expeditious manner.

### **The Limited Merits Review Regime (Appeals Process)**

A major overhaul of the merits review regime is required.

The "Yarrow Panel Review" recommended significant changes to the process, including changes that would prevent the networks from 'cherry picking' elements of the regulatory decision, and recommendations that the reviews should be undertaken by an economic institution rather than by a quasi-judicial commission.

The EUAA strongly supports the "Yarrow Panel's" recommendations.

## 1. Background

### 1.1 Recent Electricity Price Increases

As the Committee will be aware, Australia's electricity prices have risen dramatically in recent years.

Since 2007, Australia has recorded the world's highest increases in electricity prices, resulting in Australia's electricity prices now being amongst the highest in the world <sup>1</sup>

This is presenting major competitiveness challenges to Australian businesses and significant hardship for residential consumers.

### 1.2 The Contribution of Electricity Networks

It is now well understood that the majority of the price increases were due to increasing charges from the monopoly transmission and distribution networks.

For example, residential network prices in Queensland and NSW more than doubled (in real terms) between 2007 and 2013. <sup>2</sup>

Prices for large industrial consumers have risen at a higher rate, with some EUAA Members' network tariffs increasing by over 200% during that period <sup>3</sup>

Numerous expert reviews<sup>4</sup> concluded that a large proportion of the networks' price increases were unnecessary and arose from deficiencies in the regulatory framework - deficiencies that resulted in the Australian Energy Regulator (AER) approving excessive rates of return, over-investment and inefficient expenditure on electricity network infrastructure.

Those reviews outlined the need for comprehensive changes to the regulatory framework and the National Electricity Rules (NER). In response to pressure from various stakeholders, in September 2011 the AER submitted a rule change proposal to the Australian Energy Market Commission (AEMC) <sup>5</sup>; resulting in the AEMC undertaking an investigation into the effectiveness of the regulatory framework for energy networks.

As Andrew Reeves, Chair of the Australian Energy Regulator (AER), said when introducing the AER's rule change proposal - *"The current way of setting these charges leads to excessive claims by the monopoly networks and, as a result, excessive network prices"*.

### 1.4 AEMC Regulatory Rule Changes – November 2012

During the consultation processes on the AEMC review and the subsequent *AER Better Regulation Program*, the EUAA consistently advocated that the AER's proposed changes were insufficient and would not address the systemic bias in the regulatory regime towards the interests of energy networks at the expense of consumers.

The EUAA and other stakeholders submitted that a much more comprehensive reform of the regulatory framework was required.

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<sup>1</sup> UBS estimates 2013

Electricity Prices in Australia: An International Comparison, EUAA, 2012

<sup>2</sup> Utilities Policy: Independent Regulation of Government-Owned Monopolies: An Oxymoron?

<sup>3</sup> Bell Bay Submission to Senate Inquiry Into The Performance And Management Of Electricity Network Companies

<sup>4</sup> Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013

The Garnaut Review Update Paper 8: Transforming the Electricity Sector. Garnaut R. (2011)

Putting the customer back in front: How to make electricity cheaper. Grattan Institute, December 2012

Senate Select Committee on Electricity Prices: Reducing Energy Bills and Improving Efficiency

Independent Review Panel, Electricity Network Costs, Final Report

<sup>5</sup> AER's proposed changes to the National Electricity Rules, September 2011

For example, in October 2011 EUAA members supplemented the AER's rule change proposal with a proposed rule change <sup>6</sup> aimed at addressing the windfall profits being realised by electricity networks due to their cost of debt allowances being well in excess of their actual costs. Sadly for consumers, that proposal was not progressed and the networks have continued to realise extraordinary profits from their excessive allowances.

The AEMC review eventually resulted in some amendments to the National Electricity Rules being approved in November 2012 – rule changes that the AEMC claimed would result in - *“strengthening the capacity of the regulator to determine network prices so that consumers don't pay any more than necessary for the reliable supply of electricity and gas”*.<sup>7</sup>

However, in reality, the resulting amendments only represented minor changes to the previous regulations. The key deficiencies of the regulatory regime that have driven the major unnecessary increases in electricity prices still remain.

## 1.5 This Submission

This submission:

- Responds to the specific questions raised in the Senate Inquiry Terms of Reference
- Outlines the key deficiencies in the current regulatory framework for electricity networks
- Outlines the key reforms that need to be progressed to address those deficiencies, including key outstanding recommendations from previous expert reviews

Please note that the EUAA has altered the ordering of the Inquiry Terms Of Reference items to improve the flow of this submission.

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<sup>6</sup> Energy Users Rule Change Committee: Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt, October 2011

<sup>7</sup> AEMC Final Position Paper: National Electricity Amendment (Economic Regulation of Network Service Providers)

## **2. Whether Network Monopolies Should Have The Right To Recover Historic Overspending That Has Delivered Unwanted And Unused Infrastructure**

Study after study<sup>8</sup> has demonstrated that the Regulated Asset Bases (RABs) - the valuation of the electricity networks' past investments, are grossly inflated due to unnecessary and inefficient investments.

Australia's electricity system now has an installed asset base well in excess of requirements. Various political leaders and federal and state energy ministers have acknowledged that excessive gold-plating has occurred and needs to be addressed.<sup>9</sup>

Australia's electricity networks currently receive guaranteed returns on their past investments (RABs) - returns which are currently driving around 70% of their prices.

Under the current regulatory rules, the AER cannot challenge the need or efficiency of those past investments.

Whilst the recent regulatory rule changes have provided the AER with marginally more power to scrutinise future "gold plating", they do not allow the AER to address past gold plating. This is a major omission in the new rules, despite being called for by various stakeholders.

### **2.1 Who Should Pay For Poor Investment Decisions?**

In essence, the key question being asked by the Committee is – *who should bear the costs of poor investment decisions?*

The current regulatory rules require consumers to bear those costs through excessive electricity prices. Consumers and other stakeholders believe that the costs should be borne by the businesses who made those decisions – as applies to all other sectors of the Australian economy.

Clearly, providing guaranteed returns on poor investment decisions does not drive accountable capital investment. Rather, it rewards inefficiencies and locks in excessive prices for many years to come.

### **2.2 The "Death Spiral" and Stranded Assets**

The regulatory rules provide electricity networks with guaranteed revenues irrespective of the level of demand.

Over the past five years it has become apparent that electricity demand has declined and has significantly decoupled from economic growth. This has been driven in large part by consumers reducing their consumption in response to the dramatic increases in network prices. In addition, consumers are increasingly moving to self-generation as the relative costs of distributed generation are becoming more attractive, thereby further reducing the energy being delivered by the networks. The networks have

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<sup>8</sup> PIAC: Privatisation and the regulatory valuation of electricity distribution network service providers in New South Wales: Evidence and issues

The Garnaut Review Update Paper 8: Transforming the Electricity Sector. Garnaut R. (2011)

EUAA: Australia's rising prices and declining productivity: the contribution of its electricity distributors

EUAA: Transmission Network Service Providers comparison report, 25 October 2012

Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013

Putting the customer back in front: How to make electricity cheaper. Grattan Institute, December 2012

<sup>9</sup> Prime Minister Julia Gillard address to the Policy Institute of Australia, 7 August 2012

Prime Minister Kevin Rudd address to the National Press Club, 11 July 2013

Queensland Energy Minister, Mark McArdle, 1 July 2014

NSW Minister for Resources and Energy, Chris Hartcher, 9 September 2012

responded by further increasing their prices to recover their guaranteed revenues over a reduced volume.

As a consequence, network assets are becoming increasingly under-utilised and the industry's productivity is in serious decline.<sup>10</sup>

The natural outcome of the continuation of these trends is the well documented "death spiral"<sup>11</sup> - i.e. as demand continues to decline and the move towards distributed generation increases, the burden of paying for the networks' costs will be placed on a smaller consumer base until those consumers can no longer afford to stay connected to the network.

As outlined in the recent report by the *Public Interest Advocacy Centre (PIAC)*<sup>12</sup>, Australian energy consumers are already funding a significant level of "stranded assets". For example, the PIAC report concluded that a realistic value of the NSW electricity networks is around \$13 billion, rather than its current \$22 billion valuation.

### **2.3 The Asset Valuation Methodology**

Prior to 2006, the regulatory rules required that the value of the networks' regulatory asset bases (RABs) was 'optimised' to reflect the minimum value of assets needed to deliver the required services. This meant that if the networks invested in more network capacity than needed, the value of the excess capacity was excluded from their regulatory asset base until it was needed. Those rules provided a strong disincentive for over-investment.

In 2006, the electricity networks managed to persuade policy makers to make significant changes to the National Electricity Rules to better incentivise investment. One of the key resulting changes was the removal of the "asset optimisation" rules, thereby removing the only constraint to over-investment that was contained within the rules.

The networks' asset values are now determined by using the *Depreciated Optimized Replacement Cost (DORC)* valuation approach - a methodology that significantly overstates the value of the assets, and under which the asset values are inflated each year by CPI indexation – an approach that is unique to Australia.

By contrast, businesses that operate in competitive sectors predominantly use the *Depreciated Actual Cost (DAC)* valuation approach, which results in significantly lower asset valuations.

With the networks receiving a guaranteed return on their asset values, and with all capex being automatically included in the asset base without a review of its need or efficiency, the networks had very strong incentives for over-investment.

### **2.4 The Need to Optimise the Regulatory Asset Bases (RABs)**

In recent years, as it became clear that the revised asset valuation rules had driven major over-investment, various stakeholders have been advocating for RAB optimisation to be restored within the regulatory rules.

For example, in October 2011, an asset optimisation rule change was proposed and was strongly supported by various stakeholders, but was rejected by the AEMC.

With the current RABs driving around 70% of electricity prices, in order to seriously address Australia's unsustainable electricity prices it is imperative that the regulated asset bases are re-valued to more

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<sup>10</sup> AGL Submission to the AER on the NSW DNSPs Revenue Proposals, August 2014  
AER 2014 Annual Benchmarking Reports, November 2014

<sup>11</sup> The Energy Market Death Spiral - Rethinking Customer Hardship, Paul Simshauser and Tim Nelson

<sup>12</sup> PIAC: Privatisation and the regulatory valuation of electricity distribution network service providers in New South Wales: Evidence and Issues



appropriate levels.

The EUAA requests the Committee to review the calls from various stakeholders on the need to revalue the RABs, and to recommend reforms that determine a fair regulatory value for Australia's electricity networks.

### **3. *Whether The Arrangements For The Regulation Of The Cost Of Capital Are Delivering Allowed Rates Of Return Above The Actual Cost Of Capital***

In its revenue determinations, the AER determines an allowed rate of return – the *Weighted Average Cost of Capital (WACC)* - which is the AER's forecast of the funds the networks require to attract investment.

The WACC comprises the cost of two funding sources - equity and debt. The 'return on equity' is an estimate of the return that shareholders require to invest in the networks. The 'return on debt' is an estimate of the interest rate that the networks pay when they borrow to invest in the network.

It is now well understood that the AER has provided cost of capital allowances to the networks well in excess of their actual cost of capital, resulting in the networks' actual profitability being much higher than the regulatory regime assumes.<sup>13</sup>

For example, in its 2011 rule change proposal<sup>14</sup>, the *Energy Users Rule Change Committee* performed an analysis of the differences between the 'return on debt' allowances and the actual debt costs of Australia's electricity networks, demonstrating that:

- The average actual cost of debt for privately owned networks was around 250 basis points below the allowances provided by the AER
- The average actual cost of debt for publicly owned networks was around 350 basis points below the allowances provided by the AER
- These differences delivered 'windfall profits' to Australia's electricity networks of around \$1.2 billion in 2011, resulting in network prices being 12% higher than they would have been if their 'cost of debt' allowances had been based on their actual debt costs.

The recent regulatory rule changes were intended to provide the AER with greater flexibility to determine WACC allowances more reflective of the networks' actual cost of capital. However, the AER's application of its new *Rate of Return* guideline to its current draft determinations is still resulting in the provision of excessive WACC allowances.

The EUAA recommends that the Committee reviews the recent critique of the AER's approach to WACC determinations by the *AER Consumer Challenge Panel (CCP)*.<sup>15</sup>

The key points in that critique included:

- The AER has consistently set higher WACCs than other comparable regulators
- Australia's electricity networks are far more profitable than the regulatory framework assumes
- Equity markets and investors are valuing regulated businesses significantly higher than their regulated asset bases (RABs) – with some valuations at over 150% of RAB
- Lenders are lending to the regulated business at significantly lower rates than the 'cost of debt' allowances provided by the AER

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<sup>13</sup> AER Consumer Challenge Panel Submission on the NSW DNSPs' regulatory proposals 2014-19

The Garnaut Review Update Paper 8: Transforming the Electricity Sector. Garnaut R. (2011)

IPART – Changes in Regulated Electricity Retail Prices from 1 July 2012, Final Report, June 2011

<sup>14</sup> Energy Users Rule Change Committee: Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt, October 2011

<sup>15</sup> AER Consumer Challenge Panel: Smelling the roses and escaping the rabbit holes: the value of looking at actual outcomes in deciding WACC, July 2014

- The AER has inappropriately applied the discretion it has been provided under the new rules, by selecting WACC input parameters at the top end of the possible ranges

The EUAA believes that the AER must take account of the above ‘evidence and market information’, as required by the rules, to ensure that its WACC decisions achieve a better balance between the interests of the networks and consumers.

#### **4. To Ascertain Whether State-Owned Network Companies Have Prioritised Their Focus On Future Privatisation Proceeds Above The Interests Of Energy Users**

##### **4.1 The Relative Efficiency of Government and Privately Owned Networks**

As the committee may be aware, numerous reviews and benchmarking studies<sup>16</sup> have outlined the stark difference in efficiency between government-owned and privately owned electricity networks.

The key conclusions from those studies have included:

- The efficiency of the Australian electricity network sector is poor by international standards and is rapidly declining - particularly for government-owned networks
- Australia’s electricity network prices are, on average, around 2.5 times higher than those in the UK
- There are significant differences in Australia’s network prices - the most expensive Australian networks charge about nine times as much as the lowest priced networks in the UK
- The efficiency of Australia’s electricity networks is predominantly determined by ownership
- Network charges for government owned networks account for around 60% of the typical household electricity bill, compared to 30% for the privately owned networks.
- By comparison in the UK, network charges account for around 20% of the household electricity bills
- The privately owned electricity networks in Victoria are much more efficient than the networks in the other states – demonstrating significantly lower growth in revenues, regulated asset bases, capital and operational expenditure per unit of output growth
- Network prices in Victoria and SA have fallen significantly since being privatized, whereas the prices of the government owned networks have grown dramatically during the same period
- Electricity network prices in Victoria are around one half to one third of those in other states
- The prices of government-owned networks more than doubled (in real terms) between 2007 and 2013, with their asset bases and profits more than tripling during that period
- The government owned networks in NSW and Queensland have significantly younger assets than in Victoria
- If government owned networks had invested at the same rate as the private networks, customers would have saved around \$640 million per year

##### **4.2 The Excessive Profitability of Government-Owned Electricity Networks**

Various studies<sup>17</sup> have outlined the extraordinary profitability of Australia’s state government-owned electricity networks.

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<sup>16</sup> PIAC: Privatisation and the regulatory valuation of electricity distribution network service providers in New South Wales: Evidence and Issues

Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013

EUAA: Australia’s rising prices and declining productivity: the contribution of its electricity distributors

EUAA: A comparison of outcomes delivered by electricity transmission network service providers in the NEM, Oct 2012

Putting the customer back in front, Grattan Institute, December 2012

<sup>17</sup> Utilities Policy: Independent Regulation of Government-Owned Monopolies: An Oxymoron?

These outcomes stem from one of the major deficiencies in the current regulatory rules - rules that require the AER to provide WACC allowances to government-owned networks as if they are privately owned. In effect, the rules require the AER to ignore that government owned networks are funded by low cost state government debt and require the AER to provide them with 'theoretical' debt and equity raising costs that they do not incur.

This approach is unique to Australia.

The major deficiencies of this approach were highlighted in the *Energy Users Rule Change Committee's* analysis<sup>18</sup> which highlighted the extraordinary profits being realised by government-owned electricity networks, e.g.:

- In 2010 the New South Wales Government was achieving a return on its electricity networks of 29% - around three times higher than the level assumed by the AER's allowances
- A large part of these higher returns was due to the NSW government's ability to collect the profits as well as tax on profits delivered by its networks, and its practice of adding a margin to the cost of debt that it provides to its electricity networks
- The excess WACC allowances provided major incentives for government-owned networks to over-invest
- As a result, they have rapidly increased their investment levels, resulting in much higher price rises than their private sector counterparts

In its rule change proposal, the *Energy Users Rule Change Committee* proposed change to the Rules that would have resulted in the cost of debt allowances for government owned networks being more reflective of their actual borrowing costs.

The rule change proposal was strongly supported by various stakeholders but was vigorously opposed by the NSW and Queensland Governments.

The AEMC disallowed the proposed rule change on the basis that it would "not be competitively neutral", referring to the *1995 Competition Principles Agreement*<sup>19</sup> to support its decision. However, the *Competition Principles Agreement* was designed to apply to businesses that operate in competitive markets - not to regulated monopolies. Despite this fact, the AER and the AEMC continue to assume that the principles apply to monopoly electricity networks.

### **4.3 The Need to Privatised Government-Owned Electricity Networks**

In light of the above issues, the EUAA has been advocating for privatisation of government-owned electricity networks for many years. Privatisation has also been recommended by various reviews of the regulatory framework, including the 2013 Productivity Commission Inquiry Report<sup>20</sup>, which pointed to ownership as a key factor in explaining excessive prices.

The EUAA notes that the NSW and Queensland governments are currently contemplating the sale or lease of their electricity networks. It is very important that any future ownership structure for those networks eliminates ongoing funding from state treasury provided debt. If that were to continue, then the above issues would continue to prevail.

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Energy Users Rule Change Committee: Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt, October 2011

<sup>18</sup> Energy Users Rule Change Committee: Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt, October 2011

<sup>19</sup> Competition Principles Agreement – 11 April 1995

<sup>20</sup> Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013

The EUAA recommends that the Committee:

- Reviews the rationale for privatisation outlined in the above reviews and supports those recommendations; and/or
- Makes recommendations for reforms to the rules that enable the AER to determine WACC allowances that reflect the actual cost of debt of government-owned networks

**5. *The Manner In Which Electricity Network Companies Have Presented Information To The Australian Energy Regulator (AER) And Whether They Have Misled The AER In Relation To:***

- a) Their weighted average costs of capital***
- b) The necessity for the infrastructure proposed***
- c) Their regulated asset valuations***
- d) Actual interests rates claimed against actual borrowing costs***

**5.1 Outcomes from Previous Revenue Determinations**

It is now well understood that the electricity networks have taken advantage of the information asymmetry and resource imbalance in the propose/respond process, resulting in the AER approving excessive and unnecessary expenditure, including:

- Weighted Average Cost of Capital (WACC) allowances well in excess of the networks' actual cost of capital
- Excessive augmentation capex - driven by the networks' systemic over-estimation of load forecasts
- Excessive replacement capex - due to the networks' premature replacement of assets
- Excessive opex allowances - due to the previous allowances being set on the basis of historical costs rather than benchmarking
- Excessive incentive scheme payments - due to the AER setting targets well above the efficient level

This has resulted in current electricity prices being much higher than they should be.

**5.2 The Current Network Revenue Determinations**

**5.2.1 What We Should Be Seeing - Significant Price Reductions**

Australia's electricity networks are currently facing very different business drivers compared to the circumstances that the networks claimed to exist when they submitted their previous revenue proposals in 2008 and 2009.

There are a number of drivers that are producing significant downward pressure on prices, including:

- **Significantly lower cost of capital requirements** - the current costs of finance are significantly lower than the record high cost of capital allowances that the AER set for the networks for the previous regulatory period. Consequently, significantly lower rates of return are now more appropriate
- **The significant downturn in electricity consumption and demand** - demand dropped significantly over the previous regulatory period and is forecast to drop further in the next regulatory period, thereby requiring significantly lower capex and opex
- **Reduced reliability standards** – resulting in further reduced drivers for network investment, particularly since the recent high levels of network investment are delivering major improvements in network reliability
- **State Government Network Reform Programs** - that claim to be delivering major savings in capital expenditure and operating costs for government-owned network businesses

Consequently, consumers are justifiably expecting significant reductions from the current excessive prices.

### 5.2.2 What the Networks Have Proposed - Ongoing Revenue Increases

It is therefore of deep concern to consumers that the electricity networks' revenue proposals are not reflecting these changed circumstances.

All of the networks' current revenue proposals (with the exception of TasNetworks in Tasmania) have proposed to increase their revenues over the next 5 years, based on:

- **Major departures from the AER Rate of Return Guideline** – that result in a significantly higher cost of capital allowances than necessary
- **Excessive Capital Expenditure Claims** – including augmentation capex based on non-credible load forecasts, and unprecedented levels of unjustified replacement capex
- **Ongoing Opex increases** – aimed at retaining the existing inflated opex levels

Clearly the recent rule changes have not affected the networks' ability to submit unsubstantiated ambit claims to the AER.

The EUAA and other stakeholders have provided detailed submissions to the AER on the networks' revenue proposals, requesting the AER to use its regulatory powers to deliver the price reductions that consumers justifiably expect. The EUAA encourages the Committee to review those submissions, which are available on the relevant section of the AER website.<sup>21</sup>

### 5.2.3 The AER's Draft Decisions

Despite the promises that the recent rule changes would deliver consumer primacy in the National Electricity Market (NEM), the AER's Draft Determinations released in late November fall well short of delivering the significant price reductions that consumers justifiably expect.

Examples of these shortcomings are demonstrated by the AER's draft determination for TransGrid.<sup>22</sup>

TransGrid proposed a revenue increase of around 20% compared to the previous period. In its draft determination, the AER reduced that claim by approximately 18%, resulting in TransGrid's prices being maintained around current levels and continuing to increase over the next 4 years.

The EUAA believes that there are some significant deficiencies in the TransGrid draft determination, including:

- The provision of an excessive WACC allowance due to the AER selecting input parameters at the top end of the possible ranges
- The provision of a 50% increase in TransGrid's replacement capex allowance - despite an extremely critical assessment by the AER's consultant that identified major systemic deficiencies in TransGrid's project governance, risk assessment and project justification processes<sup>23</sup>
- The provision of an excessive opex allowance – with the AER's allowance being determined on the basis of TransGrid's historical costs, rather than the benchmark efficient cost

This example clearly demonstrates that the AER has not been able to apply the new rules to determine prices that reflect consumers' long-term interests.

The EUAA will strongly challenge the AER's draft determinations and encourages the Committee to review those submissions, which will be posted on the relevant section of the AER website in mid-February 2015.<sup>24</sup>

<sup>21</sup> <https://www.aer.gov.au/networks-pipelines/determinations-and-access-arrangements>

<sup>22</sup> <https://www.aer.gov.au/node/23137>

<sup>23</sup> EMCa Review of Proposed Replacement Capex in TransGrid Revenue Proposal 2014 - 2019

<sup>24</sup> <https://www.aer.gov.au/networks-pipelines/determinations-and-access-arrangements>

### 5.3 Introducing Some Balance To The Revenue Determination Process

Under the 'propose/respond' revenue determination process, the electricity networks propose their required revenues and the AER has to respond to the proposal. Importantly, the AER must provide detailed reasons if it decides not to accept the networks' proposed revenues - i.e. there is an "onus of proof" on the AER to disprove the networks' justifications.

As outlined throughout this submission, the current regulatory framework provides very strong incentives for the networks to over-state their needs – i.e. to "game the regulator".

In addition, there is a major information and resource asymmetry between the networks and the AER.

The networks have much more information available to them than the AER has access to, and they take advantage of this asymmetry in deciding the type and volume of information to provide to the AER in their revenue proposals.

An analysis of the networks' expenditure claims and the AER's annual reports suggests that, on average, the electricity networks spend around 20 times the expenditure of the AER on their revenue determinations.

It should therefore not be surprising that since the 'propose/respond' model of regulation was introduced in 2006, the networks' revenues and prices have increased dramatically.

This was predicted in the Final Report of the *Expert Panel on Energy Access Pricing* when the propose/respond model was being proposed for introduction - "*There is little doubt that a propose/respond model would over time lead to a systematic increase in returns to regulated entities relative to the 'receive/determine' model*".<sup>25</sup>

In the 'receive/determine' model, which existed prior to 2006, the regulator received and considered the networks proposals, and had the flexibility to determine an outcome that in the regulator's view best met the criteria.

The EUAA recommends that the 'propose/respond' revenue determination model should be replaced by the 'receive/determine' model that applied prior to 2006.

In addition, there is clearly a need for further reforms to the manner in which electricity network companies provide information to the AER – reforms that reduce the ability of the networks to take advantage of the inherent information and resource asymmetries.

For example, there is a clear need to reduce the networks' ability to swamp the AER with information that detracts from an effective and efficient assessment of their revenue proposals. The volume of the networks' revenue proposals is excessive, with some networks' current proposals amounting to around 40,000 pages. This makes it extremely difficult and time consuming for the AER and other stakeholders to respond effectively.

In its recent submission to the Energy Green Paper<sup>26</sup>, the EUAA recommended that the AER should develop a more streamlined process for the networks' revenue proposals; and that a limit should be placed on the volume of information (e.g. number of pages) in the networks' proposals.

The EUAA suggests that there are a number of other improvements that could be implemented to counter the systemic information and resource imbalance in the revenue determination process. The EUAA strongly encourages the Committee to consider and recommend such improvements.

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<sup>25</sup> Expert Panel on Energy Access Pricing Final Report to the MCE

<sup>26</sup> <http://ewp.industry.gov.au/submissions/white-paper>

## **6. Whether The AER Has Actively Pursued Lowest-Cost Outcomes For Energy Consumers**

It is clear that the outcomes from the AER's previous revenue determinations have not been in consumers' long-term interest, e.g.:

- The provision of WACC allowances well in excess of the networks' actual costs of capital
- The provision of excessive augmentation capex allowances on the basis of non-credible load forecasts
- The provision of excessive replacement capex allowances resulting in the networks' premature replacement of assets
- The provision of excessive opex allowances – based on inflated historical costs rather than the benchmark efficient costs
- Setting incentive scheme targets above the efficient level

The AER has previously claimed that some of the above outcomes can be explained by limitations on the AER's powers under the previous rules, although the EUAA has consistently advocated that the AER should have been much more vigilant in its scrutiny of the networks' previous revenue proposals.

However, the EUAA does not wish to be unreasonably critical of the AER and will restrict its criticism in this submission to the issue of benchmarking.

### **6.1 Benchmarking**

The EUAA and other consumers advocated for many years that the AER should have applied benchmarking to its previous determinations and that the AER was required to do so under the previous rules. The EUAA was of the view that the required data was available, and that the AER had the information gathering powers to obtain the data and information.

However, the AER did not appear to accept those views and predominantly based its previous allowances on historical costs - despite the overwhelming evidence of major differences in efficiency between the networks.

This has resulted in the provision of excessive opex allowances and excessive prices for energy consumers.

Benchmarking is an accepted and proven technique in regulatory practice - Ofgem (UK) has applied it effectively for over 20 years, and commenced it without a perfect data set.

The new rules now formally require the AER to undertake benchmarking to assess the relative efficiencies of network businesses, and to apply the outcomes to determine efficient costs for the networks. The AER's first benchmarking reports were released in late November 2014.<sup>27</sup>

In its Draft Determinations released in late November, the AER applied benchmarking to determine the opex allowances for the distribution networks - but not for the transmission networks.

As outlined within the recent presentations by the AER Consumer Challenge Panel<sup>28 29</sup>, this is a major omission in the AER's Draft Determinations.

The transmission networks have used benchmarking reports for many years to support their efficiency claims.

For example, TransGrid and Transend's current revenue proposal refer to the outcomes of various benchmarking reports including:

- The Huegen Transmission Benchmarking Study 2013 Report
- International Transmission Operations and Maintenance Study (ITOMS)
- International Transmission Asset Management Study (ITAMS)

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<sup>27</sup> <http://www.aer.gov.au/node/25078>

<sup>28</sup> Hugh Grant (CCP) Presentation on the AER'S Draft Determination for TransGrid

<sup>29</sup> Hugh Grant (CCP) Presentation on the AER'S Draft Determination for Transend

- Mercer Human Resource Effectiveness Monitor 2012
- UMS Corporate Overheads High Level Comparative Assessment

There are numerous other benchmarking reports that the AER could consider - e.g. the EUAA's *TNSP Benchmarking Report (October 2012)*.

The EUAA urges the Committee to challenge the AER to apply the extensive information available to determine efficient opex allowances for Australia's transmission networks.

Failure to do so will result in excessive opex allowances continuing for a further 5 years and will result in the inevitable correction being much more severe.

## **7. Whether The Arrangements For The Connection And Pricing Of Network Services Is Discriminating Against Households And Businesses That Are Involved In Their Own Electricity Production**

The electricity networks' current approaches to network pricing are not cost reflective.

As outlined within various submissions to the AEMC's current review into Distribution Network Pricing Arrangements,<sup>30</sup> the networks' current pricing methodologies lack transparency, produce highly variable outcomes for consumers, and do not reflect the increasing diversity in how consumers use energy.

The AEMC's draft rule change determination on Distribution Network Pricing Arrangements<sup>31</sup> states that:

*"Distribution network businesses will be subject to a new pricing objective that network prices should reflect the business' efficient costs of providing services to each consumer. Businesses will be required to comply with new pricing principles when determining the structure and level of their network prices".*

The EUAA believes that providing vague high level principles about the need for cost reflective pricing will not address the above deficiencies, and will continue to provide the networks with too much discretion in their setting of tariff structures.

The shortcomings of the AEMC's draft rule change determination were highlighted by the recent *Business Spectator* critique<sup>32</sup> of the Energy Networks Association's (ENA) position paper on tariff reform<sup>33</sup> highlighting that:

- *"The ENA has called for the regulator to give them the power to unilaterally impose their own choice of tariff on particular customers such as owners of solar and battery systems, without these customers being given any choice"*
- *"This could act to undermine the financial attractiveness of such systems by shifting a large proportion of the costs of power into a fixed charge that cannot be avoided or would be very hard to avoid by a customer changing their power demand"*
- *"Network businesses' incentives aren't really aligned with those of their customers"*
- *"What keeps the executives of these businesses up at night is the prospect that customers will use technologies which the network company doesn't have a monopoly over, to reduce their power demand"*
- *"So the ideal outcome is for these network businesses to restructure tariffs in such a way that it reduces the financial attractiveness of these potential competitors while not deterring customers from increasing their power demand"*

<sup>30</sup> <http://www.aemc.gov.au/Rule-Changes/Distribution-Network-Pricing-Arrangements>

<sup>31</sup> <http://www.aemc.gov.au/getattachment/e8ed16d5-011c-4bac-8076-eee575a5141c/Draft-determination.aspx>

<sup>32</sup> <http://www.businessspectator.com.au/article/2014/12/10/energy-markets/networks-plan-protect-themselves-competition>

<sup>33</sup> [http://www.ena.asn.au/wp-content/uploads/2014/12/Position-Paper\\_Towards-a-national-approach-to-electricity-network-tariff-reform\\_December-2014.pdf](http://www.ena.asn.au/wp-content/uploads/2014/12/Position-Paper_Towards-a-national-approach-to-electricity-network-tariff-reform_December-2014.pdf)



- *“And even better, if networks can pick and choose which customers see what tariff, then they can custom-design tariffs which penalise customers for adopting technologies that pose a potential threat to their business, while dressing these up as being all about reducing peak demand”*
- *The reality is that networks do not face the right incentives to design and assign tariffs which are in the best long-term interests of consumers as a whole”*

The EUAA believes that, rather than providing high-level principles, the rules regarding network pricing methodologies need to be much more prescriptive, and the AER needs to be provided with strengthened powers for assessing and approving those methodologies.

The EUAA encourages the Committee to review the submissions to the AEMC Distribution Pricing Arrangements Review <sup>34</sup> and to recommend changes that prevent the networks from setting pricing structures that discriminate against consumers involved in their own electricity production.

## **8. How The Regulatory Structure And System Could Be Improved**

As outlined within this submission, the recent regulatory rule changes do not address the systemic bias of the regulatory regime towards the interests of networks at the expense of consumers. In essence, the key deficiencies in the rules that have driven the unnecessary and inefficient investment and price increases have been retained.

All of the significant reforms to the regulatory framework advocated by the EUAA and other stakeholders over recent years have not been progressed.

For example:

- The recent rule changes provide the AER with marginally more powers to prevent future gold plating, but they do not provide the AER with the ability to address past gold plating. This is a highly critical issue, as the networks' past investments drive around 70% of their prices
- They didn't change the perverse rules regarding how the networks' assets are valued and inflated – rules that are unique to Australia
- In theory, they provide the AER with some additional discretion and flexibility on its approach to determining the 'Rate of Return', but as outlined within this submission, the AER appears unable to apply that discretion in consumers' interests and is continuing to provide excessive WACC allowances
- They provide the regulator with marginally more powers to scrutinise the networks' capital and operating expenditure proposals, but do not address the systemic information and resource asymmetries of the propose/respond revenue determination model
- They encourage the networks to engage with consumers and to reflect consumers' preferences in their proposals, but there are no consequences for not doing so

The EUAA draws the Committee's attention to what it considers to be the key areas of outstanding reform:

### **8.1 Determining Appropriate Values of the Regulated Asset Bases**

As outlined in section 2 of this submission, the EUAA recommends that the asset valuation process needs to be reformed to determine fair regulatory values for Australia's electricity networks.

### **8.2 The AER's Approach to Determining the Weighted Average Cost of Capital (WACC)**

As outlined in sections 3 and 4 of this submission, the AER needs to take greater account of the 'evidence and market information' outlined by the CCP <sup>35</sup> to ensure that its future WACC decisions achieve a better balance between the interests of consumers and the networks.

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<sup>34</sup> <http://www.aemc.gov.au/Rule-Changes/Distribution-Network-Pricing-Arrangements>

<sup>35</sup> AER Consumer Challenge Panel: Smelling the roses and escaping the rabbit holes: the value of looking at actual outcomes in deciding WACC, July 2014

The EUAA also recommends that the rules for the determination of the WACC should also be modified to provide the AER with the flexibility to determine WACC allowances for government-owned networks that reflect their actual cost of debt.

### **8.3 Improvements to the Limited Merits Review Regime (Appeals Process)**

As the Committee may be aware, the regulatory regime includes an appeals process whereby the networks can appeal the regulator's decision on any matter they are unhappy with. Appealing a decision is free to the networks and has no downside risk.

Unsurprisingly, the AER's revenue decisions are routinely subjected to appeals by the networks – i.e. appeal has become the norm rather than the exception. In their appeals, the networks typically “cherry pick” elements of the AER's decision (e.g. the WACC allowances) and are usually successful.

This contrasts sharply with the approach to appeals in the UK. The UK appeals process effectively re-opens the complete revenue determination, thereby exposing the networks to the risk of an unfavorable outcome on the complete decision rather than their ‘cherry picked’ elements. As a result, appeals are very rare in the UK.

The Merits Review Regime has been the subject of extensive criticism by various stakeholders, particularly in relation to:

- The high costs and litigious nature of the process
- Decisions being focused on quasi-legal/economic theory, resulting in outcomes that are not in consumers' long-term interests
- Processes that deter and disenfranchise participation by energy consumers

In response to these concerns, SCER recently established a review into the merits review arrangements. The “Yarrow Panel Review”<sup>36</sup> recommended significant changes to the process, including changes that would prevent the networks from ‘cherry picking’ elements of the regulatory decision and recommendations that the merits review should be undertaken by an economic institution rather than by a quasi-judicial commission.

The EUAA and other consumers strongly supported the Yarrow Panel's recommendations, but they were essentially rejected and significantly watered down by SCER.

The EUAA requests the Committee to review the Yarrow Panel's recommendations and to recommend the reforms to the merits review process outlined within that review.

### **8.4 Improvements to Governance and Institutional Arrangements**

The existing institutional arrangements for electricity network regulation involves two key bodies:

- The *Australian Energy Market Commission (AEMC)* - the rule maker
- The *Australian Energy Regulator (AER)* - responsible for economic regulation and rule compliance

These arrangements were reached as a result of the 2004 negotiations on the transfer of regulation from the previous state-based regulators to the new federal regulator (the AER).

The EUAA understands that during those negotiations, the states that owned electricity networks were reluctant to provide a federal regulator with full regulatory powers, and sought an arrangement that diluted the AER's powers by having a rule making body answerable to the states.

It appears that the states that continue to own electricity networks have a vested interest in seeing this

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<sup>36</sup> <https://scer.govspace.gov.au/files/2012/10/Review-of-the-Limited-Merits-Review-Stage-Two-Report.pdf>

unproductive split continue – i.e., they perceive they have less control over the AER so they continue to dilute the AER’s powers through the AEMC (which they have more control over).

The EUAA believes that there is a fundamental problem with a governance structure that separates the design and implementation of the rules. As far as the EUAA is aware, no other country has applied this separation of powers.

The AEMC’s key stated objective is - *“to promote efficient, reliable and secure energy markets which **serve the long-term interests of consumers.**”*<sup>37</sup>

As outlined within this submission, most of the key deficiencies in the regulatory framework are enshrined within the regulatory rules and are outside of the AER’s control. The EUAA urges the Senate Committee to challenge the AEMC to demonstrate how the current separation of rule making and rule implementation is in consumers’ long-term interests.

In addition, as outlined by the Productivity Commission, there is a need to *“strengthen the institutional capacity for consumers to have a voice in regulatory and merits review proceedings”*, and to ensure that *“the arrangements give consumers a formal capacity to engage with NEM institutions”*<sup>38</sup>

The EUAA draws the Committee’s attention to the fact that neither the AER nor the AEMC have consumer representation on their boards. The EUAA recommends that consumer representation is required to deliver improved governance and more balanced decision making for these institutions.

## **8.5 Reform of the Rule Change Process**

The EUAA draws the Committee’s attention to the outstanding recommendations within the Productivity Commission 2013 Report for reforms to the AEMC rule change process, aimed at delivering more timely rule changes.<sup>39</sup> As outlined within the Productivity Commission Report, critical reforms to the regulatory framework are taking far too long and there is an urgent need to introduce an accelerated (6 month) rule change process to deal with important rule changes in an expeditious manner.

## **9. Whether the current system provides adequate oversight of electricity network companies.**

The EUAA supports the recommendations from previous reviews calling for strengthened independent oversight of the electricity networks, including:

- The Productivity Commission’s recommendations for independent oversight of the Regulatory Investment Test for Transmission (RIT-T), and the expansion of the RIT-T test to cover augmentation and replacement projects<sup>40</sup>
- The need for the National Electricity Rules (NER) to be much more prescriptive regarding the pricing methodologies to be applied by the networks; and for the AER to be provided with strengthened powers for assessing and approving those methodologies.
- The Productivity Commission’s recommendation for all states to adopt contestability of new connections and separable network investments, as has successfully applied in Victoria for many years.<sup>41</sup>

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<sup>37</sup> <http://www.aemc.gov.au/About-Us/About-the-AEMC>

<sup>38</sup> Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013, Pages 10 & 11

<sup>39</sup> Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013, Page 41

<sup>40</sup> Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013, Chapter 16

<sup>41</sup> Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report, 9 April 2013, Chapters 15 & 16

- 10. *How Electricity Companies Including State Government Owned Electricity Companies Such As Energex Have Calculated The Weighted Average Cost Of Capital And How This Measure Has Changed Over Time***
- 11. *Where Anomalies Are Identified In Relation To Price Structuring Or Allegations Of Price Rorting By Electricity Companies Including State Government Owned Electricity Companies Such As Energex Are Raised, That These Matters Are Investigated By A National Independent Body Created By The Federal Government With The Required Powers And Reach To Investigate And Prosecute Where Necessary***

The EUAA understands that these issues arose from allegations by an 'Energex Whistleblower' regarding Energex's approach to estimating its proposed Weighted Average Cost of Capital (WACC). The EUAA does not wish to comment on those specific allegations and will leave it to the Committee and the relevant regulatory bodies to investigate the allegations.

However, the EUAA suggests that such investigations should consider:

- The extent to which the alleged practices are unique to Energex, or whether they actually represent common practice for all electricity network businesses when developing their WACC proposals
- Whether there are existing relevant laws and penalties that can be applied to energy network entities, and if so:
  - whether compliance with such laws (if any) is actually being monitored and enforced for electricity networks
  - whether such laws/penalties are appropriate for energy networks, or whether there is there a need for specific rules and penalties for energy networks

Furthermore, the EUAA notes that a number of the questions raised within this inquiry appear to be questioning whether the networks are engaging in misleading conduct. Again, the EUAA will leave it to the Committee and the relevant regulatory bodies to investigate those matters.

Any likely investigations should consider the extent to which the networks' systemic overestimation of their needs and expenditure drivers (e.g. load forecasts) may create the perception of 'misleading conduct'. Such perceptions can result in unnecessarily adversarial relationships and the erosion of trust, rather than the productive relationships that stakeholders on both sides of the debate wish to develop.