Major Energy Users Inc.

25 November 2014

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

Attention: Ms C McDonald

By electronic lodgment

Dear Committee

Enquiry into electricity network companies

The Major Energy Users (MEU) welcomes the opportunity to provide its views to the request for consultation on Senate enquiry into electricity network companies.

The MEU represents more than 20 large energy using companies across the NEM and in Western Australia and the Northern Territory. Member companies are drawn from many industries including:

- Iron and steel
- Cement
- Auto industry
- Paper, pulp and cardboard
- Processed minerals
- Fertilizers and mining explosives
- Tourism and accommodation
- Mining

MEU members have a major presence in regional centres throughout Australia, e.g. Western Sydney, Newcastle, Gladstone, Port Kembla, Albury, Mount Gambier, Westernport, Geelong, Port Pirie, Kwinana and Darwin.

The articles of the MEU require it to focus on the cost, quality, reliability and sustainability of energy supplies essential for the continuing operations of the members who have invested $ billions to establish and maintain their facilities.

Because the MEU members in many cases have their major operations located in regional centres, the members require the MEU to ensure that its comments also reflect the needs of the many small businesses that depend on the existence of their large operations, and the residential electricity consumers that make up the members' workforces and on-site contractors.

The MEU operates in its own right on national issues and has affiliates that represent members on regional issues in NSW, Victoria, South Australia, Western Australia and Northern Territory. It has been at the forefront of representing energy user's interests in many forums for nearly 20 years through interaction with the Australian Energy Market Operator (AEMO) and its forerunners, Australian Energy market Commission (AEMC) and its forerunner, the Australian Competition and Consumer Commission (ACCC), Australian Energy Regulator (AER), the many state based energy regulators and government departments. This interaction has involved responding to requests for stakeholder input into proposals, providing representatives to sit on working groups and oversight committees and submitting rule changes. In particular, the MEU has been active in nearly every network regulatory review to set allowed revenues to electricity network service providers (NSPs).

The MEU observes that the terms or reference (ToR) provided for this review effectively focuses on how the NSPs, have interacted with the AER in regard to their regulation. The wording of the enquiry and the questions asked imply that the NSPs are not providing sufficient and accurate information to the AER to allow it to carry out its regulatory duties properly.

What the ToR does not highlight is that the AER is constrained to act only within the National Electricity Rules (NER). In a similar way, the NSPs only have to provide the information that is required by the NER, and in the format that the NER requires. If the NER are deficient in a way that prevents the AER from exercising sensible regulation, then this is a flaw in the rule setting process rather than in the regulatory process.

The MEU considers that if there are shortcomings in the way the NSPs interact with the AER then it is due to weaknesses in the NER rather than in the way the AER regulates. And the MEU considers that it is the many weaknesses in the NER that have led to the issues raised in the ToR rather than from other causes.

1. **Propose/Respond regulation and information asymmetry**. The NER require the NSPs to propose the revenue they want and the AER has to respond to the proposal. Implicit in this approach is that the AER must have clear reasons to refuse a proposal, putting the onus on the AER to disprove the arguments provided by the NSPs to support what they want. The NSPs have every incentive to over-state their needs and attempt to "game" the regulator.

   The NSPs have much more information available to them than the AER can access in the time available to complete a revenue review. This means that the NSP is in a much better position to argue with the AER over what capex and opex the NSP considers it wants. Recent developments in the NER permit the AER to "regulate by comparison" and require the AER to develop tools to benchmark NSP proposals; NSPs attempt to overcome this regulation by comparison by countering the AER assessments with arguments that they are "different" to their comparators.

This same concern flows to the ability of the regulatory reviewer (Australian Competition Tribunal - ACT) which has exhibited a tendency to accept the NSP arguments as the AER is constrained to be a "model litigant" rather than be permitted to defend its views.

The MEU considers that the current propose/respond model of regulation should be changed to the receive/determine model used prior to 2006, before the explosion in network prices.

2. **Opex and capex allowances**. Despite recent changes in the NER, and guidelines issued by the AER in response to the changes, the MEU remains concerned that the propose/respond approach to regulation still provides the NSPs the ability to "game" the regulator in regard to opex and capex allowances that the regulator might provide as part of the regulated revenue.

   To address the information asymmetry, the AER has commenced the development of models and better benchmarking in order to counter this information bias held by the NSPs. However, the relatively "shallow" base of comparator firms on which to benchmark available to the AER means that there is still a bias in favour of the NSPs.

   The MEU is aware from direct interactions with the NSPs, that the incentives the AER uses to assist in driving the opex and capex allowances to the "efficient frontier" do not cause the regulated firms the same impetus to be more efficient as is seen when competition applies and the reality of losing market share occurs if costs are not reduced.

   The MEU considers that driving the opex and capex allowances to the efficient frontier would be enhanced if the form of regulation was changed to receive/determine and if the AER required NSPs to consult with capital intensive firms which operate in competitive markets and to share with the AER what steps firms in the competitive arena used to reduce costs. The MEU considers that if the AER extended its benchmarking activities to include performance benchmarks from the competitive sector of the market this would impose stronger drivers for NSPs to be more efficient.

3. **Redundant assets/excess capacity**. The National Electricity Code (NEC) - the forerunner of the current NER - included a requirement that

the value of the asset base of an NSP had to be optimized to reflect the value of assets that are the minimum needed to provide the service rather than automatically including actual capex. Under the NEC, this meant that if an NSP provided more assets or capacity than needed, then the value of the over-supply was excluded from the asset base until it was needed to provide the service. In an era of declining consumption and demand, such a control would impose greater constraints on NSPs on continuing to "grow" their asset base.

When the NER on network regulation were rewritten in 2006 (transmission) and 2007 (distribution), it was decided that optimization would provide a disincentive to needed investment and the ability under the NEC for the regulator to be able to exclude assets that are unnecessary was specifically removed, thereby removing a constraint to limit over-investment by NSPs.

This view that optimization should not be included in the rules persists even now despite the MEU proposing a rule change in 2011 to include optimization but which was rejected by the AEMC. The MEU contends that, by not limiting NSPs to just providing sufficient assets for the provision of the electricity services that consumers need, has allowed NSPs carte blanche to over-invest with impunity.

The structure of the NER leads to an assessment of NSP revenue based on the "building block" approach to determine the allowed revenue. This approach results in the profit that an NSP is allowed is related entirely to the value of the assets it provides, thereby incentivising an NSP to over-invest if it can and to replace existing assets with new assets as this increases the asset base. Under the building block regulatory model, the larger the asset base, the greater the profit an NSP receives thereby incentivising investment.

The MEU considers that optimization of the asset base should be re-introduced to the NER as proposed by the MEU in 2011.

4. **Asset valuation.** The approach allowed in the NER for asset valuation provides for automatic inclusion of any investment made by an NSP subject to some, as yet unproven, controls. As noted in point 3, investment is incentivised and when this is compounded with the propose/respond regulatory approach (see point 1), there is little doubt that over-investment is more likely to occur than not.

   The current high values of electricity network assets was locked into the rules in 2006 (transmission) and 2007 (distribution) as the rules declared what each network asset value was to be. These asset values were assessed using the Depreciated Optimized Replacement Cost (DORC) valuation approach which has been discussed recently in the press as a flawed methodology as it overstates the value of the assets[1]. In contrast, competitive industry uses the Depreciated Actual Cost (DAC) valuation approach which delivers a much lower asset valuation.

Compounding the over-statement of asset values derived from the DORC approach, governments included in the asset values, allowances for easements that were either unsubstantiated or were based on assessments related to the value of the land over which the power lines ran. In some cases the values of easements were assessed on the actual recorded costs involved with the acquisition of the easements (not an unreasonable approach) but what concerned consumers was that there was little or no recognition that some or all of the costs would have already been "expensed" by the easement acquirer and therefore already paid for by consumers, recognising that some easements had been acquired up to 100 years previously.

5. **Weighted cost of capital**. The weighted cost of capital (WACC) is effectively driven by three basic assessments - the return on equity, the cost of debt and the gearing (ratio between debt and equity).There is some relativity between the cost of debt and gearing, as the higher the gearing the higher the cost of debt as higher gearing increases the risk to lenders, so to some extent these two aspects are related.

    a. Return on equity. The NER allow a number of approaches to be used to assess the cost of equity and this provides the NSPs the opportunity to select the best outcome for themselves. The AER has prepared a guideline on how it considers the cost of equity will be calculated but most NSPs are not following this guideline and are seeking higher values for their cost of equity. To assess the reasonableness for the return on equity, comparisons should be made been what was allowed by the AER at a reset with what the NSP actually achieved and between what was allowed and with what the general market achieved at the same time. These comparisons will give a better view as to the what the AER should allow at a reset but these benchmarking comparisons are not carried out to demonstrate the effectiveness of the NER and the AER guidelines in providing outcomes that are equitable.

    b. Cost of debt. The MEU considers that the cost of debt is no different to any other cost that a firm incurs. This means that the actual cost that the NSP incurs from its debt should be used rather than an artificial assessment made of what the cost of debt might be at some time in the future. The argument provided against this approach is that using actual costs of debt will lead to NSPs not trying to minimise the cost. The MEU view is that debt

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[1] See http://www.smh.com.au/business/mining-and-resources/gas-industrys-depreciation-formula-a-licence-to-print-money-20140914-10gtrm.html#ixzz3DLmtxJa7 and http://www.smh.com.au/business/dorc-rort-the-art-of-getting-energy-infrastructure-paid-for-twice-20140919-10jega.html#ixzz3DrHSld3u

can be treated in the same way opex is, with a cap provided on the cost coupled with a sharing scheme to incentivise lower costs.

The AER guideline developed from the NER provides a cost of debt allowance which is based on the highest cost source of debt and the AER considers this provides an incentive to the NSP to minimise its cost of debt. What is intriguing about providing an incentive for the NSP to minimise its cost of debt is that there is no mechanism for the lower cost to be passed onto consumers. The AER guideline also makes some assumptions that result in higher levels for the cost of debt than are actually incurred by NSPs. Overall, the effect of the NER and the AER guideline provides an outcome where consumers pay considerably more for the debt than the NSPs do, giving the NSPs significant unearned revenue.

c. Gearing. The AER guidelines reflect a lower gearing than is seen by the actual performance of the NSPs. This lower gearing results in consumers paying a premium for the WACC as debt is sourced at a lower cost than providing equity as it has a lower risk profile.

Rather than discuss in detail the views of the MEU in this response, the MEU refers the committee to two submissions made to the AER regarding the issue of WACC.

The first is from the MEU in response to the AER draft guideline on rate of return[2]. This highlights the MEU view that the AER guideline is too conservative and will lead consumers to paying a higher rate of return to NSPs than is warranted. The AER final decision provides a slightly better outcome for NSPs than its draft guideline.

The second report is more recent and is a paper[3] presented to the AER Board from its Consumer Challenge Panel (CCP). This also highlights that the AER guideline does not address some key aspects and that the guideline provides a better outcome for NSPs than is warranted. In particular this paper highlights the need to better benchmark elements of the WACC derivation as the current approaches used lead to higher than required WACCs.

The MEU considers that the AER rate of return guideline needs to be modified to reflect the suggestions made by the MEU and the CCP and that the AER guideline should be enforced by the rules rather than allow

[2] This is available at http://www.aer.gov.au/sites/default/files/MEU%2C%20submission%20to%20draft%20AER%20rate%20of%20return%20guideline%20-%2010%20Oct%202013%20.pdf

[3] This is available at http://www.aer.gov.au/sites/default/files/CCP%20report%20prepared%20for%20AER%20Board%20-%20Rate%20of%20Return.pdf

the NSPs the ability to "pick and choose" the approach that gives the best outcome for the NSPs rather than one which provides a return just sufficient for the needs.

6. **Network pricing.** There is little doubt that the current approaches to network pricing are less than cost reflective. In fact, its has been seen that networks subject to price cap regulatory controls have used pricing to garner higher revenues than were expected from the AER revenue reset process. In its report Stage 1 Framework and approach paper Ausgrid, Endeavour Energy and Essential Energy, March 2013[4]. On page 51 of the report, the AER comments:

> "We consider the [weighted average price cap] WAPC provides an opportunity for distributors to recover revenue systematically above forecast. That is, under a WAPC distributors have the opportunity to recover revenue substantially above forecast revenue when actual quantities exceed forecast quantities, and to recover revenue close to forecast when actual quantities are below forecast quantities. Revenue recovered by NSW and Victorian distributors under WAPCs is provided in Appendix F."

This clearly shows that the NSPs have the ability, the tools and the interest to use network pricing to enhance their profitability.

The MEU undertook a review of the actual prices and outcomes from pricing methodologies used by electricity NSPs and reported the outcomes to the AEMC as part of its review of network pricing. This report[5] highlights that network pricing does not follow clearly definable price paths but exhibit widely variable outcomes for consumers. This excessive variability results in allowing NSPs to increase their revenues as noted by the AER and at the same time impose massive cost swings on consumers. The ability of NSPs to vary their prices at will reflects the extreme flexibility allowed NSPs in their pricing approaches and the lack of definition on what pricing is required to achieve for consumers.

The MEU is aware that the AEMC is currently in the process of implementing rule changes to address network pricing issues but the MEU notes that it's recently released draft new rules to apply to network pricing, still allow the NSPs considerable flexibility to continue to set prices much as they wish. It is the MEU's view that the draft new rules will not result in much improvement in network pricing and will not

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[4] Available at http://www.aer.gov.au/sites/default/files/AER%20-%20Stage%201%20Framework%20and%20approach%20-%20NSW%20distributors%20-%20March%202013_1.pdf
[5] Available at http://www.aemc.gov.au/getattachment/afb96f8f-37bf-4496-8456-bc11896ce23c/Major-Energy-Users-supplementary-submission-%E2%80%93-rece.aspx

overcome the problem the AER has identified with over recovery of revenue through use of pricing. The MEU has responded[6] to the AEMC highlighting its concerns with the proposed new rules on pricing.

To limit the ability of NSPs to "game" network pricing to enhance their revenues and to provide consistency in network pricing across the entire NEM, the MEU considers that the NER should be directive on how network pricing is to be implemented by each NSP.

We appreciate the opportunity to have provided this input into this Senate inquiry.

We request that you keep the undersigned aware of any future discussions and requests for further stakeholder involvement in relation to this review.

Yours faithfully

David Headberry
Public Officer

[6] This response is available at http://www.aemc.gov.au/getattachment/5c63c5f8-b594-4644-a877-615cfc15ce9b/Major-Energy-Users-received-21-October-2014.aspx