EUAA Presentation to AEMC Workshop on TFP

1 February, 2010

Melbourne Airport Hilton

Overview

Compelling evidence of regulatory failure

The track record of energy network regulation

So, why has it gone so wrong ?

Is TFP a solution?

Some suggestions on way forward

(Focusing on electricity here, not gas, but similar issues arise)

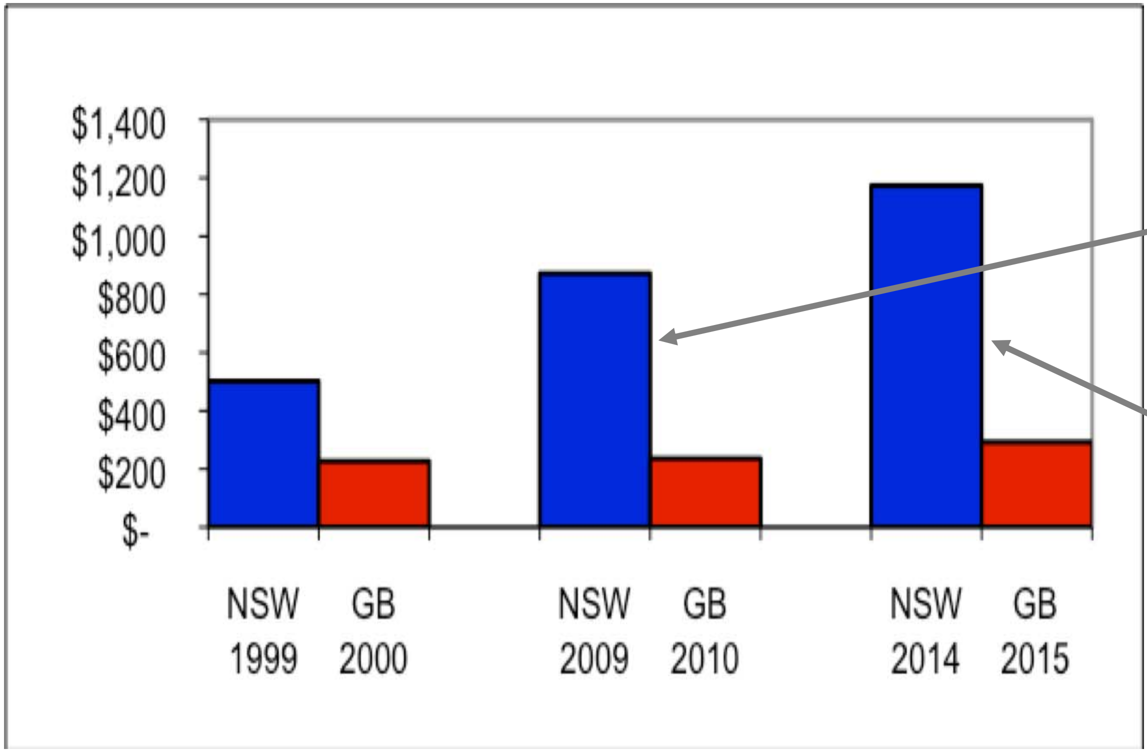
“Building blocks” in Australia has delivered very high rates of return for a long time …

AER decision (as amended by Australian Competition Tribunal) has delivered 7.5% real Vanilla WACC. Ofgem has recently proposed – and GB distributors accepted – 4.75%. Big impact on network prices.

Only a small part of difference is explained by short term differences in risk free rates. Most attributable to:

1. **Equity beta:** AER chose 1; Ofgem uses 0.24
2. **Cost of debt:** AER sets margin on top of risk-free rates; Ofgem uses trailing yields on corporate bonds

“Building blocks” has delivered drastic loss of productivity



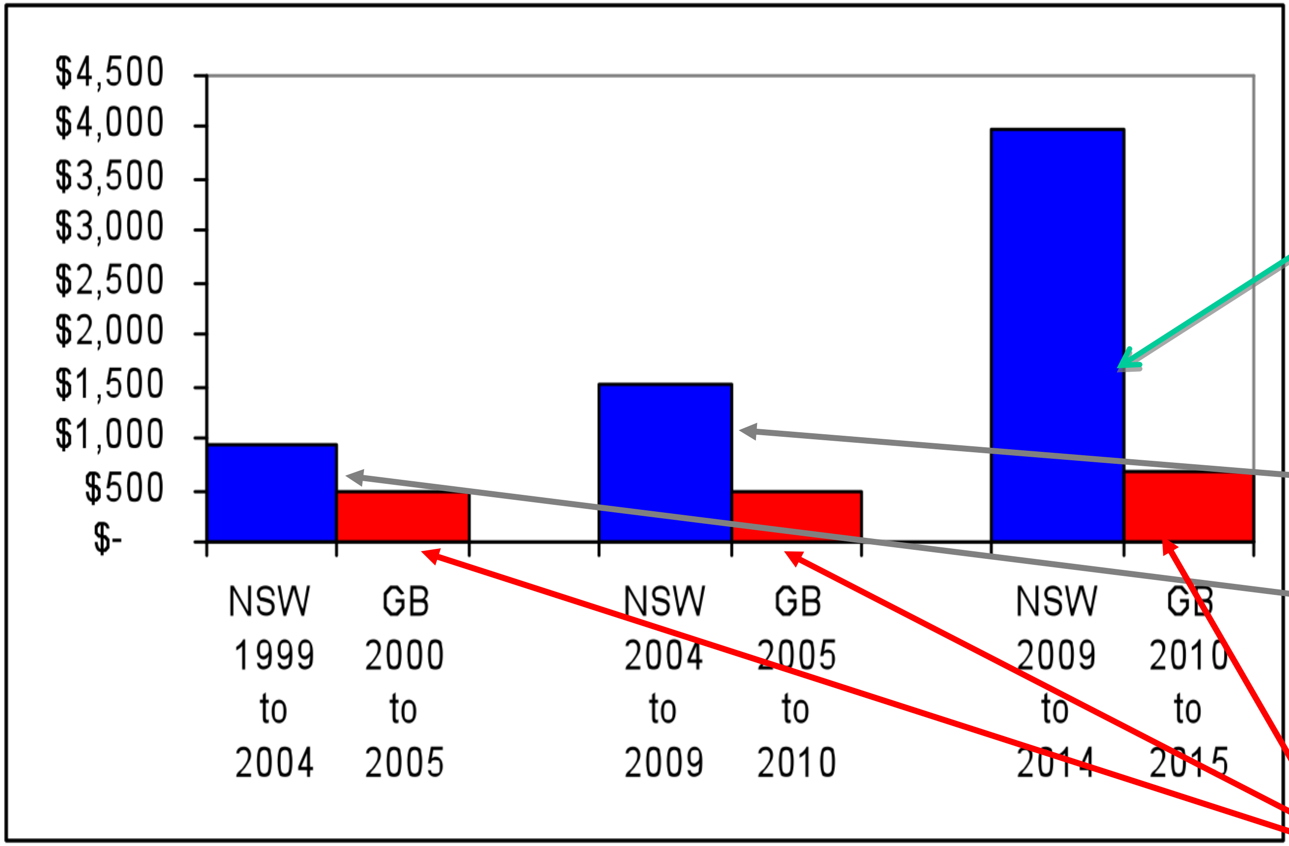
Average distributor regulated revenue per customer in NSW now 4 times higher than in Britain!

By 2015 it will be 6 times higher … so the gap is getting bigger

NSW network businesses probably the worst performers, but the same trends can be seen in the performance of other government-owned distributors

Source: Mountain and Littlechild 2009, Page 3

Regulators have allowed expenditure – particularly capex – to blow out …



Average NSW distributor allowed capex is 6 times the average distributor in Great Britain …

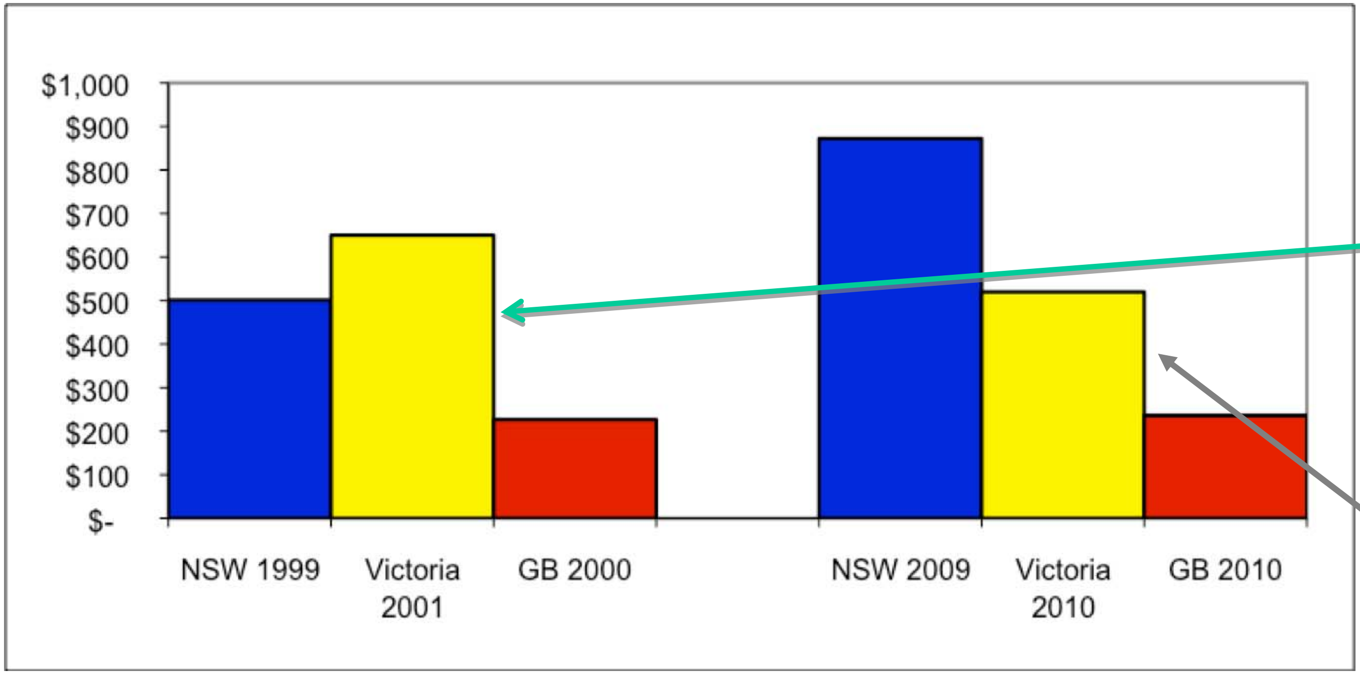
… 5 years ago it was only 3 times …

…10 years ago it was only double …

… capex growth in GB far less

Source: Mountain and Littlechild 2009, Page 4

There has been better performance in Victoria, despite higher demand and customer number growth …



Distributor revenue per customer in Vic was 30% higher than NSW in 2000

… now its 40% lower.

But Vic price control by the AER is now under-way. This could see the same massive expenditure increases that the AER has allowed for Transend, TransGrid, Powerlink, Energy Australia, Integral and Country Energy?

Source: Mountain and Littlechild 2009, page 20

AER has chosen to rely on *ad-hoc* "bottom-up" expenditure assessments …

1. Expenditure assessment by AER is "bottom-up" expenditure reviews & ignore the first lesson of regulatory economics – information asymmetry is a trap for regulators.

2. Benchmarking of capex is not done and there have been limited attempts at opex benchmarking in only some decisions – merely as a "high level sense check".

3. Benchmarking said by AER to be only a "long term proposition"; and "just one of 10" (opex and capex factors) – but the only one that is being virtually ignored?

Regulatory Track Record in a Snapshot

- Useful initial inroads into monopoly rent
  - Mainly due to decisions that lowered WACC
- Now ballooning expenditures, especially capex
- Productivity in opex no longer evident
  - What if our whole economy stalled on productivity?
- Gaming of regulators is a new ‘art form’
- State Govt ownership a festering sore
- Service levels a mixed bag
  - Some advances in Vic & SA
  - Approach in NSW, Qld and Tas still immature

… Track Record …

- Prices (where the rubber hits the road for users)
  - NSW – 50-70% increases (next 5 years); 30-40% on 1st July 2009; Tas transmission also
  - Qld & Vic heading the same way; SA a little less
  - Impacts of this on non-regulated businesses (operating costs increase, competitiveness lost, investment put at risk, jobs too)
  - Observe impacts on CPI – 16% of 2009 increase due to higher electricity costs; 22% in NSW; more to follow

CPI-X was the regulatory mantra users asked to believe…

… *CPI + X* is the reality (where *X* is a big number)!

Energy users are beginning to ask if they would be better off returning to the 'good old days' when Ministers decided electricity prices, not regulators? This is becoming a serious question.

So, why has it gone so wrong?

- Here are a few possibilities of the underlying problem:

  - Chapter 6 and 6A are badly flawed (viz. misdirected burden of proof, cherry-picking appeal mechanism, “propose-respond” handicaps the regulator – as it was intended to do, timelines are absurd, customer engagement severely handicapped).
  - Do the deep flaws in Chapter 6 reflect a deficit of political independence as well? Is there a will to change them?
  - Is the AER sufficiently political independent? MCE appoints Chair and one member but MCE can have a forked tongue; is AER unwilling to take on state government owned network businesses; does it have the quality and metal to take on well resourced interests?

What role should TFP have in solving the problem?

- There appears to be a fundamental governance problem attributable to continued regulatory shortcomings, government ownership & regulatory capture. In this context, is focusing on TFP a bit like tilting at windmills?
- Ideally, better to put the fundamental problem on the table and then consider the full scope of fundamental solutions:
  - Privatisation ot networks;
  - Governance (independence, appointments to and roles of regulators);
  - Methodological (the Rules and their implementation).
  - Institutional (design of AER and AEMC, relationship to each other, MCE and ACCC);
- But is there an appetite for fundamental ownership & regulatory reform at this point. If not the 2^{nd} best course is how methodological approaches (of which TFP is one) can help to better a bad lot? But foundations will still deliver underperformance and poorer outcomes

EUAA thoughts on the way forward …

- Whilst we recognise this is an AEMC rule change about TFP, should first consider full range of comparative techniques (of which TFP is but one) that offer prospect of expenditure assessments that place much greater emphasis on efficiency demonstrated by ‘frontier’ companies, in setting expenditure allowances (rather than relying on the AER’s “bottom up” assessments)
  - This is approach Ofgem successfully adopted for setting expenditure allowances covering around 2/3rds of distributor expenditure, over last 15 years. Results have been far better than here
- Perhaps the appropriate next step for AEMC is to focus its resources on developing a more holistic and wide-ranging assessment of all comparative exogenous (benchmarking) approaches and how these can take effect through the Rules

… way forward …

- But to get to nub of matter need to go beyond this & AEMC rule change into policy
  - Get rid of propose-respond – delivering greater inefficiencies
  - Focus on effective regulation instead – get back regulation that mimics competitive market outcomes
  - Get rid of appeals (asymmetric and only deliver dead weight economic losses)
  - Have single national transmission and distribution reviews – promote holistic approach and use of ‘tops down’ benchmarking. GB can do it so why not here?
  - Encourage ‘customer engagement' (see Littlechild presentation at 2009 ACCC regulatory conference for his useful ideas)