

16 April 2012

## Lodged online

Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear Commissioners,

### **Submission to the Network Regulation Rule Change, Directions Paper (REF: ERC0134)**

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Australian Energy Market Commission's (the **AEMC**) Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Directions Paper (the **Directions Paper**).

### **About Consumer Action**

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. We provide free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and are the largest specialist consumer legal practice in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

We also operate MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians experiencing financial difficulty.

### **Introduction**

Consumer Action wishes to express a general concern about the approach taken by the AEMC to the Australian Energy Regulator's (**AER**) Rule change proposal in this Directions Paper. We believe the AEMC needs to recognise that the proponent of this Rule change is an independent economic regulator, as opposed to an agent representing a specific self-interest. The AEMC is guided by the National Electricity Objective and the National Gas Objective (together, **the objective**) when determining the National Electricity Rules and National Gas Rules (the **Rules**) and if the independent economic regulator believes that the Rules do not adequately promote efficient investment in, and efficient operation of, electrical services in the long-term interest of consumers, the AEMC should give weight to the suggestions made based on the regulator's actual experience.

### **Consumer Action Law Centre**

Level 7, 459 Little Collins Street Telephone 03 9670 5088  
Melbourne Victoria 3000 Facsimile 03 9629 6898

info@consumeraction.org.au  
www.consumeraction.org.au

In this Directions Paper the AEMC often takes the approach where it seeks evidence of a causal link between the Rules and the outcomes described by the AER (e.g. evidence that the Rules have directly contributed to higher than necessarily network charges). We understand that analysis and evidence are important tools for policy and rule-making but in this Directions Paper the AEMC appears to use the lack of proof to justify inaction. It is not always possible to produce 'proof' and most 'proof' will still come down to whether the decision maker is willing to accept it. We remind the AEMC of its own guidelines for rule change proponents, which more accommodatingly requests supporting evidence to be provided *where possible*:

“For the proponent to best support its views, the AEMC requests that statements of fact be supported with evidence where possible and include quantitative and/or qualitative analysis to support statements regarding the effect of a proposed Rule.”<sup>1</sup>

After all, the role of the AEMC is not to be an arbitrator between the regulator and the network businesses, or between network businesses and consumers. Its role is to ensure that the Rules support outcomes in line with the objective.

Furthermore, Consumer Action notes that while the AEMC is an *independent* Rule maker it also has very close ties to the Standing Committee on Energy and Resources (**SCER**). For example, the AEMC provides advice to the SCER, the SCER nominates the appointment of the AEMC Chair and Commissioners etc. In this context, Consumer Action wishes to express concern about jurisdictional differences when it comes to ownership issues. The National Energy Market (**NEM**) has one governance and regulatory model but includes different ownership models. The AEMC is required to make Rules that further the objective but it must not be forgotten that in some jurisdictions these Rules may affect State Governments' revenue stream. We are not claiming that the AEMC is influenced by State Governments' revenue concerns, however we are raising the issue as the unfortunate situation exists where there are uniform objective, law, rules and regulatory frameworks but different ownership structures, and this might result in a framework that works better in some jurisdictions than others.

Consumer Action also wishes to note a general concern in relation to analysis commissioned by the AEMC and the appropriateness of the consultants selected. In particular, we believe the commissioning of SFG Consulting to provide advice to the AEMC on the rule change proposals insofar as they relate to the estimation of the weighted average cost of capital (**WACC**) is problematic. SFG Consulting recently provided advice to network businesses appealing the AER's decision to the Australian Competition Tribunal. SFG Consulting, via their website, explains how their analysis helped secure ETSA Utilities, ENERGEX and Ergon Energy several hundred million dollars more in revenue:

“The AER's criticisms of the SFG study were rejected by the Tribunal who relied entirely on it in finding that the appropriate estimate of gamma was 0.25. The Tribunal expressed its confidence in the SFG econometric analysis noting that they were “persuaded by SFG's reasoning in reaching its conclusions,” drawing attention to our “comprehensive responses” and concluding that that “no other estimate has any claims to be given weight vis-à-vis the SFG report value.” The reduction of this parameter from 0.65 to 0.25

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<sup>1</sup> AEMC, National Electricity Rules – Guidelines, Guidelines for proponents: Preparing a Rule change proposal, January 2012, p 2

results in the allowed revenues of the three Applicants increasing by several hundred million dollars over the five-year regulatory period.”<sup>2</sup>

Consumer Action understands there is limited expertise available in Australia on these highly technical matters. However, as consumers continue to feel the pain of on-going increases to their energy costs, we would understand if households feel uneasy that the AEMC, for this important review, have sought advice from a consultancy proudly announcing that it has secured several hundred million dollars from consumers to the benefit of the companies’ shareholders.

Our comments on the more specific issues discussed in the Directions Paper are set out below.

## Forecasting

Consumer Action strongly supports the AER’s Rule change proposal in relation to forecasting capital and operating expenditure. The AEMC may seek “more evidence to understand the drivers for increases in network costs, and the extent to which the NER approach to capex and opex forecasts is contributing to this”, however we believe that the AER’s experience to date provides enough evidence for concern.<sup>3</sup> Basically, the AER has produced price determinations for thirteen electricity network businesses under the current Rules, and the AER’s experience is that Chapters 6 and 6A of the National Electricity Rules (**NER**) are too restrictive and thus do not allow them to adequately interrogate and amend the network businesses’ forecasts. Consumer Action believes that the AEMC could apply more of a *prima facie* approach to the AER’s statement, e.g. the NER does restrict the AER unless there is evidence that the AER has interpreted the Rules wrongly. We urge the AEMC to consider the *implementation* of the Rules, as experienced by the AER, in assessing whether the Rules facilitate the NEL objective.

The AEMC states:

“A key issue for this Chapter, and indeed for the directions paper in general, is whether, and if so to what extent, the NER contribute to network charges that are higher than necessary to meet the relevant objectives. This provides evidence of how the NER are working in practice, which is important to supplement the consideration of how the NER work in theory. The Commission considers that the level of analysis provided by stakeholders of the drivers for network cost increases to date has been limited and there may be scope for further analysis to inform the Commission’s assessment.”<sup>4</sup>

Consumer Action does not believe the AEMC is applying the right approach to its assessment. The AEMC wants concrete evidence that the NER has directly contributed to higher than necessary network charges. Clearly there are a number of factors that can result in increased network costs and it is, from time to time, acknowledged that the issues are not the same for all

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<sup>2</sup> SFG Consulting website, see [www.sfgconsulting.com.au/projects/view/etsa\\_utilities\\_energex\\_ergon\\_energy\\_v.\\_australian\\_energy\\_regulator\\_2010\\_11](http://www.sfgconsulting.com.au/projects/view/etsa_utilities_energex_ergon_energy_v._australian_energy_regulator_2010_11)

<sup>3</sup> AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Directions Paper, 2 March 2012, p 14

<sup>4</sup> AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Directions Paper, 2 March 2012, p 21

jurisdictions/network businesses.<sup>5</sup> The Directions Paper refers to SP Ausnet's submission which refers to the Ernst and Young analysis into network cost increases.<sup>6</sup> The AEMC could interpret the differences this analysis shows between, for example, Victoria (on one hand) and Queensland and NSW (on the other hand) as an indicator that the AER needs more flexibility in determining forecast proposals.

The key issue is that network costs have increased significantly in some jurisdictions and if the AER believes changes to the Rules can prevent unnecessary increases in the future, the AEMC should seriously consider the proposals and focus their assessment on whether the changes may produce detriment to consumers or undermine the objective. If the proposed changes do not cause detriment or conflict with the objective, the AEMC should focus on improving the Rules rather than requiring evidence of concrete causal links between Rules provisions and increases in network costs.

The current Rules give the network businesses an upper hand in the determination process to the detriment of consumers (but to the benefit of their shareholders). Consumer Action recommends that the AEMC changes the Rules to ensure that there is a greater onus placed on the network businesses themselves to justify expenditure proposals rather than requiring the AER to approve any proposal that reasonably reflects the capital expenditure criteria.

### **Capital expenditure incentives**

As stated in our submission to the AEMC's Issues Paper, we are deeply concerned by the Rule's current incentives that as they allow for any capex to be rolled into the network businesses' asset base for the next regulatory period.

Consumer Action does not share all of the concerns raised by the AEMC and other stakeholders' regarding the AER's 60 per cent proposal but we do agree that such an arrangement can create perverse incentives. Our key focus is thus on possible solutions to remove the current incentives for the network businesses to defer capex. Amongst the suggested options, Consumer Action would like the AEMC to continue exploring approaches that allow for an ex-post prudency review of capex, as these can at least address the lack of supervision problem. However, if the evidentiary burden placed on the AER is excessive, ex-post efficiency and prudency reviews are unlikely to be of much benefit.

Prof. Littlechild states in his AEMC-commissioned paper that:

“As regards incentives, it is taken for granted that the companies will tend to build some ‘fat’ into their projections of opex and capex. The aim of the regulatory price control process just described is to challenge those assumptions and allow only a reasonably efficient level of cost. Once the price controls are set, it is assumed that the companies will seek to minimise their operating and capital costs”.<sup>7</sup>

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<sup>6</sup> AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Directions Paper, 2 March 2012, p 18 and Ernst and Young *Victorian domestic electricity prices 1996-2010: The contribution of network costs*, A report for the Victorian electricity network businesses, September 2011.

<sup>7</sup> Littlechild, *Advice to the AEMC on Rule Changes*, 11 February 2012, p, 9

Consumer Action's view is that no energy consumer should be satisfied with a regulatory framework where it is basically acknowledged that the network businesses tend to build some 'fat' into their projections. As such, we urge the AEMC to ensure that the Rules provide the AER with better and more tools in order to allow it to properly and efficiently regulate.

The AEMC for some reason appears to think it has to protect status quo, even if its Rules come across as cumbersome and dated to others. As stated in Prof. Littlechild's paper:

"The UK energy regulator Ofgem has in practice been quite innovative in addressing the forecasting and incentive challenges to which the AER refers—as indeed have other utility regulators. They have tried new ideas and revised them in the light of experience. In contrast, the Australian Rules have the look of an approach that is set in stone, reflecting the approach that was current at the particular time that the Rules were set, but now looking cumbersome and dated."<sup>8</sup>

Consumer Action supports IPART's suggestions, summarised in the Directions Paper as:

"IPART considers it appropriate to include in the NER a range of mechanisms given the ownership and governance arrangements of NSPs. It considers that the AER's sharing mechanism proposal should be supplemented with an ex-post review of expenditure. It also suggests that rolling incentive mechanisms be further explored."<sup>9</sup>

We cannot ascertain why the AEMC would want to restrict the AER's ability to develop and test incentive models. In Consumer Action's view, allowing the AER to test new incentive schemes is likely to produce innovation and, ultimately, better regulation. We recognise that the design of incentive schemes poses challenges, but we do not agree with the AEMC's view that potential risks are a valid reason not to proceed at all. The AEMC states "there is a risk that new incentive schemes could be introduced that lead to unexpected and perhaps unwelcome outcomes"<sup>10</sup>, but surely this risk is present every time changes to the regulatory framework occurs. The AEMC proposes to only allow for the AER to introduce small-scale pilot schemes to mitigate this risk. Consumer Action questions whether the AER would be able to produce adequate levels of evidence of effective incentive schemes for the AEMC if the evidence is only derived from small-scale pilots.

Finally, we are also concerned about the AEMC's view in relation to cost of capital and how this affects the efficiency incentive arrangements. Consumer Action cannot understand why the AEMC does not believe the cost of capital and rate of return affect the incentives. As pointed out by Bruce Mountain, it is our clear understanding that:

If a network business has a lower cost of capital than the regulator thinks it has (and has allowed it in setting its prices) then the network business will trade-off the disadvantage of losing the return (and possibly also depreciation) on any overspend during a

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<sup>8</sup> Littlechild, Advice to the AEMC on Rule Changes, 11 February 2012, p, 8

<sup>9</sup> AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Directions Paper, 2 March 2012, p 38

<sup>10</sup> AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Directions Paper, 2 March 2012, p 62

regulatory control period, against the benefit of a higher return than it requires for the rest of the life of the asset. As such, network businesses may prefer to spend more than they are allowed to during the regulatory control period because this maximises their profitability.<sup>11</sup>

## Rate of return frameworks

The AER has proposed a framework that includes periodic reviews of the rate of return parameters, which are then fixed and apply to all pricing determinations. The AEMC's preliminary view is "that the rate of return framework should not prescribe the methodology or values for parameters, but rather provide guiding principles."<sup>12</sup>

Consumer Action believes that the framework does not need to prescribe methodology or values for parameters *if* the access to merits review is removed. Consumer Action has continuously argued for the repeal of the NEL provisions that enable network businesses access to merits reviews in relation to price determinations. The network businesses should instead use their rights to judicial review if they want to test whether the AER's process of making the decision was reasonable, whether the decision was within the power of the AER and that it was not so unreasonable that no reasonable decision maker would have reached that conclusion.<sup>13</sup> If the access to merits reviews of pricing determinations is upheld, the Rules should be amended to exclude "decisions by the AER on whether or not persuasive evidence has been established in relation to a particular parameter value, method or credit rating as part of a distribution determination"<sup>14</sup> from being subject to merits reviews. Consumer Action believes that the network businesses will always appeal rate of return decisions simply because of the large amount of money they can potentially gain from it.

We are aware of the SCER review into the merits review regime, but we raise this as an issue for this review because we do not believe it is possible to design the Rules for price determinations without considering appeal arrangements.

Consumer Action has previously argued that appeal arrangements should not be considered entirely separate from the overall regulatory framework.<sup>15</sup> Rather, the appeal arrangements should complement the regulatory framework in place.

The appeal arrangements and the regulatory framework for price determination are flip sides of the same coin. As such, the level of prescription applied to the methodology or values for parameters should reflect the appeal arrangements for network pricing determinations.

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<sup>11</sup> Based on explanation provided by Bruce Mountain, CME, *Advice notes confidential to Roundtable members*, 30 March 2012.

<sup>12</sup> AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Directions Paper, 2 March 2012, p 66

<sup>13</sup> Consumer Action Law Centre and Consumer Utilities Advocacy Centre, *Barriers To Fair Network Prices*, August 2011, p 13

<sup>14</sup> AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Directions Paper, 2 March 2012, p 70

<sup>15</sup> Consumer Action Law Centre and Consumer Utilities Advocacy Centre, *Barriers To Fair Network Prices*, August 2011

## Regulatory Processes

In a presentation to the National Consumers Roundtable about the Directions Paper, the AEMC stated that it will “assess whether there are opportunities to better reflect consumers preferences in the process”<sup>16</sup>, while noting that there are currently no barriers in the Rules to the AER or the network businesses to engage with consumers.

Consumer Action believes there is value in formalising a minimum standard/level for consumer consultation for price determination in the Rules. Such formalisation would contribute to an enhanced understanding of the role of the regulator and its task in understanding consumer issues and concerns. As Ofgem has argued:

“The better we understand the needs of existing and future consumers, the better able we are to tailor the regulatory framework to meet their interests. We do not have complete information on consumer interests, or on the extent to which networks are meeting those interests. We have therefore recognised, since privatisation, the need to engage with consumers, and their representatives, to understand their interests better.”<sup>17</sup>

The Rules currently include many highly prescriptive clauses in relation to the regulatory process (including the minimum/maximum number of days allowed between the different stages of the process), and Consumer Action believes it would be appropriate if the Rules included a formal requirement for the AER to consult consumer groups during that process.

In regards to the AER’s proposal in relation to confidentiality and submissions made by the network businesses to their own revenue proposals, Consumer Action strongly supports the views and recommendations put forward by the AER.

Firstly, in relation to submissions, we cannot find one valid argument for why the network businesses should be given the opportunity to make submissions to their own proposals. As they already have the opportunity to submit revised proposals, these submissions only confuse the information flow and create an obstacle for other stakeholders participating in the price review process.

Secondly, in relation to information provided in confidence, we are surprised by the view presented by the AEMC. Consumer Action simply does not understand how the AEMC envisage a process of broader stakeholder and consumer involvement if key information can be withheld from them. This was experienced first hand by Consumer Action and the Consumer Utilities Advocacy Centre in their efforts to intervene in the appeals process:

“Being unable to access relevant information creates another challenge for consumer groups. For example, information provided to the AER as commercial- in-confidence may be referred to in the issues raised in the Distributors applications for leave and

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<sup>16</sup> AEMC, AEMC Directions Paper on Network Regulation Rule Change Requests, Presentation to National Consumers Roundtable, Melbourne 22 March 2012, p 7

<sup>17</sup> Ofgem, Regulating energy networks for the future: RPI-X@20, Delivering outcomes: Consumer engagement in the regulatory process, p 2

review, but third parties are not granted access to this information when developing their applications for leave to intervene.”<sup>18</sup>

We believe there are ways to deal with commercially sensitive and/or confidential information and understand that some information is not suitable for online publishing. However, consumer groups are, from time to time, privy to confidential information (typically by government departments) and there are many simple measures that can be used to ensure that such information is protected (signing confidentiality clauses, a right to view documents rather than obtaining copy etc). Consumer Action recommends that the AEMC explore ways to ensure that all stakeholders can participate in transparent and meaningful price determination processes, and thus look to introduce measures that minimise the risk for network businesses required to expose commercially sensitive information.

Consumer Action is concerned, however, about the apparent emphasis on consumer involvement as a solution to fix all the flaws in the regulatory framework, including both network price determinations and review arrangements. The AEMC-commissioned paper by Prof. Littlechild explores opportunities for more direct consumer involvement in the economic regulator’s decision-making process. A report commissioned by the Energy Networks Association (ENA) into the merits review provisions in the Australian energy laws explores increased consumer involvement in the merits reviews in order to play a role as a contradictor to the network businesses.<sup>19</sup> In both cases more resourcing and enhanced information to consumer groups are regarded as key measures to promote consumer participation.

In our view, while consumer participation in the price-setting process is important and necessary, consumer groups are unlikely to ever have the resources or information required to effectively participate as a negotiator/decision-maker in price determination processes or contradictor in merits review processes.

Secondly, and just as importantly, there is *not* one single consumer voice. This is partly why the AER has a mandate to make decisions according to the Rules, which are guided by the objective. As such, the AER is consumers’ proxy in the decision-making process. Clearly, the AER needs to consult with consumer groups during this process (in order to make informed decisions in the long term interest of consumers). However, the AER is not an arbitrator between network businesses and various consumer interests. For such an arrangement to work, most of the AER’s resources and expertise would have to be transferred to a Consumer Agency with the economic regulator taking the role of a Tribunal. Clearly, this is not an arrangement desired, let alone proposed, by anyone.

As far as we are aware, there is no actual experience with direct consumer involvement in price determination in markets comparable to the NEM.<sup>20</sup> As discussed in the paper by Prof. Littlechild, there has been recent interest in increasing consumer participation in price determinations in the UK. However, if these new regulatory arrangements are implemented they

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<sup>18</sup> Consumer Action Law Centre and Consumer Utilities Advocacy Centre, *Barriers To Fair Network Prices*, August 2011, p 54

<sup>19</sup> Professor Allan Fels, *The Merits Review Provisions in the Australian Energy Laws*, Report for Energy Networks Association, March 2012.

<sup>20</sup> We are aware of arrangements in the US but we do not believe they lend themselves to useful comparison for NEM arrangements.

would not be tested in practice before 2020 (the RPI-X@20 decision) and Ofgem has expressed some caution in relation to the model.

In a ‘thinking paper’ on how they can better engage consumers in the regulatory process to “improve the quality, transparency and legitimacy” of their decisions, Ofgem highlighted a range of problematic issues raised in their consultation on the issue and there was no consensus amongst stakeholders on how to ensure effective consumer engagement.<sup>21</sup> IPART, in its review of customer engagement refers to such direct involvement in price determination processes as a *constructive engagement* model and it notes the need for a “considerable commitment to the process, as well as a degree of expertise and sufficient resources”<sup>22</sup> in order to ensure effective engagement by consumers/consumer groups.

Consumer Action is of course broadly supportive of reviews and research into models for enhanced consumer engagement. Our concern in this context is that consumer engagement has been proposed as an alternative approach or solution to key issues raised in the Rule change proposal and can thus create a distraction from the main issue, which is the AER’s decision-making powers. This Rule change proposal is about improving the Rules to ensure that the regulator has the ability to make determinations that promote efficient investment in, and efficient operation of, electrical services in the long-term interest of consumers.

As such, solutions to the problems currently experienced by the regulator in relation to the Rules should not only focus on how to improve consumer participation. We believe the network businesses are arguing for improved consumer participation in price determinations and merits reviews as an alternative to the actual reform being sought, which is wholly inappropriate and inadequate.<sup>23</sup>

## Summary

As summarised by Prof Littlechild, the AEMC’s Directions Paper poses four main questions:

- Whether participants agree with the nature of the problem
- Whether the proposal achieves the right balance between prescription and discretion
- Whether the AER could already achieve the outcome sought through the use of existing discretion
- Whether the solution proposed is the preferred solution, or whether a more preferable solution exists

To sum up, we briefly answer the three first questions (as preferred solutions have been addressed above): Consumer Action agrees with the nature of the problem (broadly speaking)

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<sup>21</sup> Ofgem, *Regulating energy networks for the future: RPI-X@20, Delivering outcomes: Consumer engagement in the regulatory process*, p 1

<sup>22</sup> IPART, *Customer engagement on prices for monopoly services*, Research – Discussion Paper, February 2012, p 17

<sup>23</sup> For example, the Littlechild paper contains the following quote from Jemena’s submission: “Jemena strongly supports better resourcing for consumer groups so they can be more a part of the price review process from start to finish, have a much deeper level of understanding of the issues, and provide meaningful input into the AER’s decisions being made on consumers’ behalf” see Littlechild, *Advice to the AEMC on Rule Changes*, 11 February 2012, p, 13 and Fels, *The Merits Review Provisions in the Australian Energy Laws*, argues that reforms should be considered to promote consumer participation in merits reviews.

raised in the AER's proposal. We believe the proposal contains solutions that can *improve* the balance between prescription and discretion. However, as noted above, we believe the regulatory process for price determinations must be assessed in the context of appeal arrangements. And, finally, as to whether the AER already has the discretion to achieve the outcomes it is proposing, we believe this is a purely theoretical debate. If the AER does not believe it has, it will not act as such, and hence the outcomes will not be achieved.

Should you have any questions in relation to this submission, please contact me on 03 9670 5088.

Yours sincerely

**CONSUMER ACTION LAW CENTRE**

A handwritten signature in black ink, reading "Gerard Brody". The signature is written in a cursive style with a large, prominent 'G' and 'B'.

Gerard Brody  
Director Policy & Campaigns