3 October 2012

Australian Energy Markets Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Sirs,

Submission on AEMC Draft Decision Reference ERC0134/ERC0135/GRC0011

The Energy Users Association of Australia (EUAA) welcomes the opportunity to provide a submission to the AEMC on its Draft Decision on proposed changes to the National Electricity Rules and National Gas Rules.

The attached submission represents the view of the EUAA and, in respect of the section on the return on debt arrangements, the views of the Energy Users Rule Change Committee.

Yours faithfully,

B Green

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Chairman

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Submission to the Australia Energy Market Commission on its Draft Decision on changes to the National Electricity Rules proposed by the Australian Energy Regulator and the Energy Users Rule Change Committee

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EXECUTIVE SUMMARY

This document is the Energy Users Association of Australia (EUAA) submission to the Australian Energy Market Commission (AEMC) on its Draft Decision on proposals from Energy Users Rule Change Committee to change the National Electricity Rules, and from the Australian Energy Regulator (AER) to change the National Gas Rules and the National Electricity Rules.

The EUAA advocates on behalf of large energy users and has around 100 members. Over the last five years our members have suffered extraordinary and unreasonable price rises, mainly as a result of higher regulated charges by the network service providers (NSPs) in the NEM. Flaws in the Rules have contributed to this.

The EUAA had hoped that the AEMC's Draft Decision would deliver changes to the Rules that would help to address the price rises and that would help to ensure much tougher regulation by the AER. We are not convinced that the AEMC's Draft Decision achieves either of these.

The AEMC has made three main decisions on changes to the National Electricity Rules proposed by the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC):

1. Government-owned service providers should continue to get a return on debt as if they are privately owned.
2. If the AER rejects an NSP's capex or opex proposal, it is no longer required to determine a substitute amount "only to the extent necessary" and "on the basis of the regulatory proposal".
3. The AER has discretion to determine the allowed rate of return subject only to the principle that it should reflect the cost of capital of a benchmark efficient firm.

Of these three decisions, the first is the most significant. If the AEMC had accepted the EURCC's proposal, it would have reduced the revenue recovered by government-owned electricity network service providers (and paid to their State Government owners in the form of debt fees) by around $1bn per year. Assuming this change had taken effect in 2010, the average prices charged by those service providers would have been around 14% lower than they were.

The AEMC has rejected the EURCC's proposal mainly on the basis that it contravenes the Competition Principles Agreement, and for other reasons. We disagree with the AEMC's reasoning, as set out in this submission.

The AEMC's second decision (listed above) is a useful elimination of an ambiguity and we suggest helps to ensure that the AER will feel less constrained by NSP's proposals, in setting capex and opex allowances.

The third decision would be significant if it was the case that the AER was constrained by the Rules. However we do not believe that to be the case. The AER has had full discretion in setting the Weighted Average Cost of Capital (WACC) for gas pipelines and gas distributors, and the ACCC had similar discretion for transmission network services providers (before 2006). The evidence shows that the AER made similar WACC decisions when it was unconstrained by the Rules, as it did when subject to the constraints in Chapters 6 and 6A in the Rules. Therefore we can not conclude that additional regulatory discretion for the AER in the determination of the WACC will *necessarily* make any difference to future decisions by the AER on the WACC.

In addition to these three decisions, the AEMC has also decided a number of less significant changes (elimination of a debateable ambiguity in relation to benchmarking, allowing ex-post adjustment of capex allowances, requiring the AER to publish seven new guidelines on various issues, lengthening the regulatory decision process and putting additional steps into the process, requiring greater transparency on late submissions and the withholding of information claimed to be confidential, and encouraging the AER and NSPs to provide more information to consumer representatives).

Our assessment of these decisions is as follows:

- We do not expect that the elimination of (debatable) ambiguities in benchmarking will make much difference – the Rules already say that the AER must have regard to benchmarks in setting expenditure allowances.
- The decision to allow ex-post adjustment of capex is difficult to assess, but on balance we are not convinced that it is helpful.
- Our expectation is that the publication of additional guidelines and the lengthening of regulatory decision processes will not simplify regulatory decisions or necessarily lead to better decisions.

While neither the AER nor the EURCC proposed changes to the Rules to empower consumers, our conclusion is that the provisions that the AEMC has made to encourage greater engagement by the AER and NSPs with consumer representatives, are unlikely to make much difference to the disempowerment of consumers in regulatory processes.

Our assessment, in summary, is therefore that the AEMC's Draft Decision is unlikely to result in noticeable differences in the decisions that the AER will make in future, compared to what they would have made if the Rules were left as they currently stand. Certainly we consider that it is not possible to conclude that these changes will reduce electricity prices in future compared to what they otherwise would have been.

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1. Introduction

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In this submission, each section begins by summarising the AEMC's Draft Decision on each element of the proposed changes, followed by our assessment of the AEMC's Draft Decision.

2. Rate of return framework

The AEMC has proposed that the AER has full discretion to determine the rate of return for each NSP subject to a general requirement that this return be based on a benchmark efficient NSP. The AER is also required to determine non-binding guidelines – to be revised at least every three years. The purpose of these guidelines is to provide some predictability to the AER's approach and to allow stakeholders to engage constructively in regulatory debates, without necessarily having to be involved in the same debates during each regulatory determination.

Assessment

The AER has and has had complete discretion to determine the allowed rate of return for gas network service providers. Until the revised arrangements for Chapter 6 took effect, it had similar discretion in the determination of the allowed returns for transmission network service providers.

Since the revised Chapter 6 and new Chapter 6A took effect, the AER has had less discretion in electricity, but still a substantial level – other than in the determination of the risk free rate and debt risk premium, and other relatively less significant differences between the arrangements in chapters 6 and 6A.

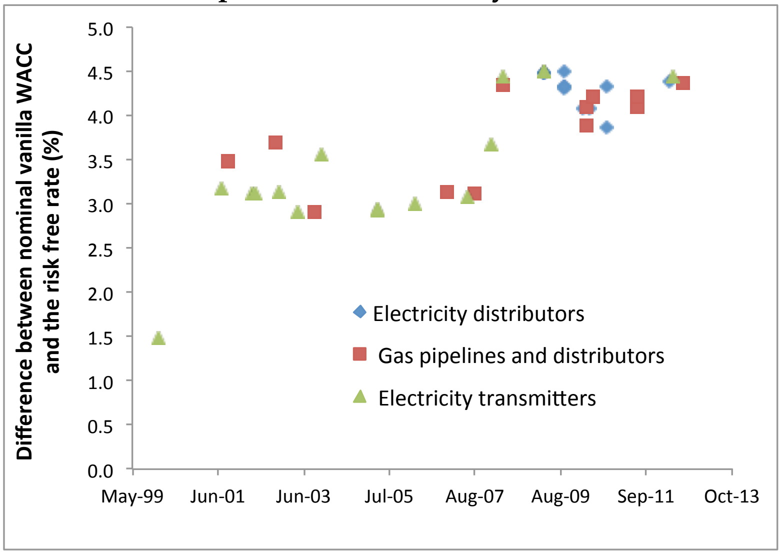
To inform an assessment of what greater freedom for the AER in this area might deliver, we have compared outcomes in the AER's regulation of gas pipelines, and also of transmission network service providers until the revised Chapter 6 took effect, with the outcomes that have been delivered since the implementation of Chapter 6 and Chapter 6A.

In total this covers 40 regulatory determinations that the ACCC and then the AER has made since 2000 for covered gas pipelines, gas network service providers, electricity transmission network service providers and electricity distribution network service providers.

The analysis is of the difference between the nominal vanilla weighted average cost of capital (WACC) less the risk free rate. Some of these decisions were varied on appeal to the Australian Competition Tribunal (ACT). We have used the AER and ACCC's decisions not the ACT's varied values, because we are interested in understanding the AER's decisions not the ACT's decisions.

The results of this analysis are presented in Figure 1 below.

Figure 1. Difference between the nominal vanilla WACC and the risk free rate in all network service provider decisions by the AER and ACCC



Source: AER and ACCC regulatory decisions

A number of conclusions can be drawn from this analysis:

- The ACCC determined comparable WACC for gas pipelines and distributors and electricity transmission network service providers.
- The AER has determined comparable WACC for gas pipelines and distributors and electricity transmission and distribution network service providers.
- The step up in the determination of the WACC since 2008 corresponds to the implementation of the arrangements in Chapter 6 and Chapter 6A of the Rules. But there were no changes in the determination of the WACC for gas network service providers and yet the AER determined a WACC for gas network service providers that is comparable to that for the electricity network service providers.

This analysis supports the conclusion that the AER's concern that it has not had sufficient discretion in the determination of the WACC of electricity network service providers is hard to sustain. This is because it has had complete discretion in the determination of the WACC for gas network service providers and yet has delivered a comparable WACC to the level it has determined for electricity network service providers.

On the basis of this assessment we conclude that greater discretion for the AER in the determination of the allowed return, though generally desirable, has not influenced WACC determinations in the past and so may not do so in future.

3. Return on debt

The Energy Users Rule Change Committee (EURCC) proposed changes to the allowed return on debt. The AEMC distinguished between the EURCC's proposal to have the return on debt contingent on ownership (private and government), from the EURCC's proposed changes to the methodology for the calculation of the return on debt.

For the latter, the AEMC has agreed that there is a problem, and has decided to strike out the current Rules provisions on the method for the determination of the risk free rate and debt risk premium. It has also decided that the AER should determine the return on debt using whatever approach it considers appropriate.

For the former, the AEMC has disagreed with the EURCC that the return on debt for government-owned service providers should be calculated differently to privately owned service providers. The rest of this section explains and critiques the AEMC's reasoning.

The AEMC has decided that the Rules should not determine a different allowed return on debt for government owned NSPs, compared to their privately owned peers. It provided various reasons for this. The Draft Decision (DD) provides no new reasoning beyond what the AEMC set out in its Directions Paper, however the DD has a different emphasis on various issues, and clarifies and further reinforces the AEMC's Directions Paper reasoning in various areas:

The AEMC's reasoning in the DD to support its conclusion is as follows:

1. There would be allocative inefficiency if the states do not charge (and users do not pay) competitive neutrality fees.
2. Tax-payers would be subsidising electricity users if there was no competitive neutrality fee.
3. The income taxes that state governments receive on the profits of their NSPs should not be counted as a return on equity (and hence by implication state governments are not receiving extra-ordinary returns on their investment in NSPs).
4. There is competition for the services provided by NSPs and hence the Competition Principles Agreement should apply to NSPs; and
5. Irrespective of the merits of any other argument, the state governments say that the Competition Principles Agreement as they have interpreted it applies, and so whatever fees they calculate pursuant to this agreement, can be recovered from users in regulated charges.

We think that none of these arguments withstand scrutiny. The rest of this subsection sets out our views.

Allocative inefficiency

The AEMC suggests that unless competitive neutrality fees are charged, the return on debt will be "artificially" low. It then says (page 85) that "'*faced with an artificially lower rate of return, the service provider may view capex solutions as comparatively lower cost to non-network solutions*". By implication, if competitive neutrality fees are not charged, the AEMC suggests NSPs will overspend (what the AEMC calls "*over-investment*" on page 86).

But later on the same page, the AEMC contradicts this by arguing, that "*it is arguably more likely that reducing the rate of return for state-owned service providers in the way proposed by the EURCC could lead to under-investment by the relevant service providers because the state governments may choose to restrict their access to debt capital*".

These arguments are internally inconsistent – how can the elimination of debt fees result in under-investment and over-investment at the same time?

Leaving aside this internal inconsistency, we suggest that the AEMC has erred because it has ignored the reality that NSPs (that the governments own) are accountable to their government owners and so the cost of debt that they might see (after debt fees payable to their State Treasuries) is not relevant in their investment decision-making.

To expand on this point, NSPs' investment decisions are made by Boards, appointed by the state governments and whose task it is to represent the interests of the governments. These governments (and their appointed Board representatives) can be expected to consider the interests of their shareholder when approving the investments of the NSPs that they govern. In this case, they can be expected to make decisions that align the interests of the NSPs that they govern, with the interests of the shareholder whose interests they have fiduciary duties to protect.

In this context, competitive neutrality fees are simply a form of transfer payment, and Boards can be expected to see through them to the underlying economic substance – which is the difference between the cost of debt to the Government and the return on debt allowed to the NSP by the AER. The relevant issue therefore is the size of the difference between the allowed return on debt (that the regulator determines for the NSP) and the actual cost of debt raised by the state government treasuries.

If NSPs are rewarded with a higher return on debt than is the cost to their governments to provide that debt, then the government shareholder (and its representative the NSPs' directors) have an incentive to encourage their NSPs to increase their debt.

The existence of competitive neutrality fees is simply a matter of how the government extracts the surplus that arises from the difference between the return on debt and the cost of debt: if there is no fee, attributable profits will be higher (and the states have a claim on these profits and incomes taxes thereon). If there is a fee, the profits will be commensurately lower but the government gets the fee. Exactly the same income accrues to the government in both cases, and their attitude to investment by their NSPs should be exactly the same in both cases.

It follows from this analysis that the relevant allocative efficiency issue is the gap between the cost of debt and return on debt, not the existence (or absence) of competitive neutrality fees. Therefore such fees (or their absence) can not be expected to have any meaningful impact on allocative efficiency.

Tax-payers would be subsidising electricity users if there is no competitive neutrality fee

The Government, on behalf of tax-payers, provides the equity and debt capital that funds the NSPs that they own. The argument of whether tax-payers (the government) are funding electricity users or vice versa therefore needs to have regard to all the pecuniary benefits that the government, as an investor, receives on its investment in its NSPs.

The EURCC's proposal document analysed the situation in NSW (based on data provided by the NSW Auditor General) and calculated that from its electricity transmission, distribution and retail businesses, the NSW government received a return of 28.3% on its equity in these business in 2010.

Of this, the competitive neutrality fee on debt (from the distribution and retail businesses – and almost all of this will been from the distribution businesses) accounted for $221m, or a 5.3% equivalent return on the government's equity in its distributors.

If we assume that this fee was not charged, the rate of return on equity would decline to 23%. This is still more than twice the rate of return on equity that the AER considers to be reasonable, in its determination of the Weighted Average Cost of Capital. In what sense then, is it reasonable to argue that taxpayers would be subsidising electricity users if there is no competitive neutrality fee?

Income taxes that state governments receive on NSP profits should not be counted as a return on equity

Whether or not income taxes should be counted as a return on equity is not directly relevant to the treatment of the return on debt. Its value in the discussion is however whether such tax returns should be classified as a return on the government's equity in its NSP. If so, this strengthens the case that the governments should not also profit on debt costs through competitive neutrality fees.

On the advice of its consultants (SFG), the AEMC concluded that the return received by governments as a shareholder (as dividends) should be compared with the risk borne as a shareholder and that taxation revenues received as the taxing authority should have no part in this comparison.

This argument seems implausible. Income taxes arise from the profits that NSPs deliver, and when the government owns the NSPs, these profits accrue to the state government because the Australian Constitution precludes the Commonwealth from taxing state-government activities. The fact that NSPs don't incur risk to earn the income tax is irrelevant. As the owner, the state government is entitled to both the profit and the tax on the profit. If the government ceased to be the owner it would be entitled to neither. To argue, as the AEMC does on the advice of SFG, that a dollar received by the government through income tax on the profits of its NSP is different to a dollar received by the government from the dividends on the NSP's profits, is to argue that administrative form should triumph over economic substance.

There is competition for the services provided by NSPs and hence the Competition Principles Agreement should apply to NSPs

The AEMC argues (on page 86) that state owned "electricity service providers" are in competition with "the gas sector" and "other electricity networks" although strangely it considers this to be the case mainly in QLD, less so NSW and does not mention what might be the case in the rest of the NEM. By implication the AEMC suggests that the Competition Principles Agreement should apply (because the NSPs compete) and hence competitive neutrality fees should be included in the prices for their services. We note that the AEMC reaches the opposite conclusion on competition amongst NSPs (on page 167) where it concludes "*the NSP is a monopoly business and does not therefore compete directly with other businesses*".

The argument that there is a meaningful level of competition in the services provided by monopoly network service providers is surely unsustainable. The AEMC's latter conclusion (that there isn't) is sound, and the former must be discounted, and with it the rationale for the application of the Competition Principles Agreement to NSPs

The Competition Principles Agreement applies to network monopolies because the states say that it does

The AEMC says (on page 81) that "*the most important factor to recognise is that state-owned service providers that are subject to the NER are required to pay debt neutrality or government guarantee fees to the jurisdictional government (via state treasuries) as part of the application of the competitive neutrality principles. These fees are mandated in various state legislation and code of practice instruments*".

By implication, the AEMC suggests that it has no discretion in this matter and that even if it agreed with the EURCC's arguments there is nothing it can do about it because state-owned NSPs have obligations imposed on them by their jurisdictional government owners. By implication, whatever obligations the state governments impose on their NSPs, the AEMC is required to accept.

There seems to be a double standard here. The AEMC has proposed regulations to deal with related-party contracts that privately-owned NSPs might enter into, to protect users from cost-shifting that could be achieved through this. Competitive neutrality fees extract values from NSPs and pass it to their government owners. They are, in substance, just like transfer pricing arrangements that might be negotiated between related parties.

The AEMC is right to guard against such transfers in related party contracts. Competitive neutrality fees are no different.

The National Electricity Law requires the AEMC to create and administer rules that serve the long term interest of consumers. At face value this says that the AEMC's task is to set rules that ensure that users can not be forced to bear charges unless they are in their long term interest. In this case, the AEMC's evaluation of competitive neutrality fees must rest on the argument that such fees are in the long term interest of consumers, not that the states have imposed them. The AEMC's Draft Decision has done the opposite.

On the basis of the EURCC's proposals, the AEMC's response to those proposals and this reply to that response, we fail to see how reasonable argument can be sustained that competitive neutrality fees are in the long term interest of consumers.

4. Capex incentives

The AEMC has decided several changes to the arrangements for regulatory incentives in respect of capex. The main changes proposed are as follows:

- The AER is able to undertake ex-post reviews of actual capex, and if it considers actual expenditure above the amount allowed in the regulatory control has been inefficient, to then ensure it is not included in the regulated asset base.
- The AER can decide whether to use actual or forecast depreciation in its calculations.
- The AER can design capex efficiency benefit sharing schemes.

Of lesser significance, the AER can preclude inefficient related party margins or capitalised opex from being rolled into the RAB.

Assessment

The AEMC has decided that the AER should have a significant degree of freedom in designing capex incentives. This extends the freedoms that the AER already has, such as the use of Efficiency Benefit Sharing Schemes, but which it has not used.

In principle regulatory discretion in the design of incentives is important. Incentive design is complex, and intrinsically empirical. It is essential that the regulator is able to learn from past experience. This is difficult if incentives are controlled through the Rules. In principle therefore, the AEMC's proposals in this area are desirable and necessary.

However, the only area in which there is a significant departure from the current arrangements is in respect of the opportunity afforded to the AER to consider ex-post capex reviews, and to exclude some expenditure from the regulated asset base, if the AER considers that such expenditure has been inefficient.

There are arguments for and against ex-post optimisation. The argument for them – in terms of their impact on efficiency – is that the threat that the regulator will assess expenditure as inefficiently incurred, acts as a discipline on expenditure network service providers. This is because there will be a reduction in financial returns if investors rather than consumers are left to carry the burden of inefficient expenditure, and adverse ex-post assessments can be expected to carry significant reputational risk for the NSPs' executives.

Government owned service providers have historically spent far in excess of the capital expenditure allowances in their regulatory controls. Energy users have been burdened with almost all of the additional costs. One wonders whether such overspending would have occurred if regulators had been able to use ex-post expenditure assessments.

The main argument against the adoption of ex-post controls is that network service providers can be expected to argue that this risk of ex-post assessment will increase their investment risk and hence require compensation through higher allowed returns on equity. It is not clear that the AER will be able to withstand this argument. Therefore what might be gained through greater discipline on expenditure will be lost on higher allowed rates of return.

In addition, ex-post expenditure assessments are very demanding to do. A reasonable ex-post adjustment must be able to focus on the information available to NSPs at the time they committed expenditure, and be able to conclude that the NSPs had failed to reasonably take account of that information and hence had spent more than they should have. This is a lot to ask of a regulator.

Our concern therefore is that the threat of ex-post adjustment may turn out to be an idle threat, but which NSPs will be able to capitalise on by claiming that it increases investment certainty and hence is a basis to allow higher regulated rates of return. In this case the inclusion of ex-post expenditure assessments will do more harm than good. On balance we incline to this view.

5. Determination of opex and capex allowances

The AEMC has made two changes in this area. The first is to strike out clause 6.12.3(f) from Chapter 6. This is a significant change. The second is to take out the words "circumstances of the relevant NSP" in relation to benchmarking.

Assessment

Clause 6.12.3(f) (which is in Chapter 6, but not 6A) says that if the AER refuses to approve part of an NSP's proposal it must determine a substitute amount "only to the extent necessary" and "on the basis of the regulatory proposal". The AER has suggested that this has constrained their ability to set an efficient level of expenditure.

The extent to which this has constrained the AER is debatable. However we agree with the AEMC that this clause serves no useful purpose. The AER should be able to determine an efficient expenditure allowance subject to general requirements, and we can see no reason why it should be constrained to make adjustments based on only NSPs' proposals. This is the origin of our significant concern about "onus of proof" (the clause elevates the NSP's proposal to the status of the document against which changes by the regulator are to be referenced. The AEMC's draft decision addresses this concern, and the NSP's proposal no longer has such special status. We agree with this important change.

We also agree that the excision of the requirement that the AER must have regard to the "circumstances of the relevant NSP" in its benchmarking is helpful. This requirement does not distinguish between endogenous factors (which benchmarks should ignore) and exogenous factors (which they shouldn't). Excising this requirement will avoid wasteful argument, and perhaps embolden the AER in developing benchmarks.

6. Regulatory processes

The AEMC has made what it calls "incremental" changes to the current regulatory determination process. Other than the consumer empowerment related changes discussed in the next section, these propose changes are to:

1. require NSPs to identify confidentiality claims, and the AER to report on these claims;
2. require the AER to report on its website where it receives late or out-of-scope material from NSPs' proposals;
3. increase the time for NSP to prepare revised regulatory proposals;
4. introduce a discretionary cross-submissions stage; and
5. commence regulatory determinations six months earlier.

Assessment

These changes seem reasonable and may address some concerns about the abuse of regulatory processes by NSPs and of their claims to confidential information. However, as the AEMC notes, these changes are "incremental" and we suggest have no great value in affecting future regulatory outcomes.

7. Consumer engagement

The Executive Summary of the Draft Decision has a section entitled "consumer engagement and participation" that describes various actions that the AEMC suggests should be taken to "attempt to address a lack of focus on consumer engagement and participation". There is no section of the Draft Decision specifically dealing with this, but its covered within a section entitled "regulatory determination process". The AEMC's proposals are that:

1. NSPs must say how they have engaged with customer representatives in their regulatory proposals, and the AER must take this into account when setting the extent to which NSPs have engaged with consumers in preparing their forecasts;
2. The AER should publish an issues paper after receiving the regulatory proposal to "assist consumer representatives to focus on the key preliminary issues";
3. The AER must publish a benchmarking report to inform consumers on the relative efficiency of NSPs.

Assessment

Neither the EURCC nor the AEMC made proposals to change the Rules to improve consumer engagement. These proposals have therefore been developed by the AEMC independently of any rule change proposals.

The first area – requiring NSPs to report on customer engagement and then requiring the AER to take account of this - is potentially meaningful. It is possible to imagine an outcome consistent with this proposal, in which NSPs and user representatives engage with each other with a review to reaching a negotiated settlement on prices and services. The AER's task would then be to verify that this was a fairly negotiated settlement, that the parties to the negotiation represented their respective constituencies, and that the resulting settlement served the public interest. This "negotiated settlements" approach is commonly used in the regulation of NSPs federally in Canada and the U.S, and in some states of the U.S. and provinces in Canada (for example Florida, California and Alberta).

However, it is not clear that this is what the AEMC has in mind. We imagine that the AEMC's intention is that the consumer engagement that it would like to see the AER and NSPs undertake is really about "consultation" and the provision of information so that consumers are better informed about the NSPs proposals and the AER decisions, presumably so that the resulting decisions (and price rises) win greater acceptance amongst consumers. Assuming that this is the AEMC's intention then this proposal, like the other two, is perhaps useful. But it should not be imagined that this constitutes what might be considered to be "empowerment" in the commonly accepted meaning of the word.

With regard to the second and third areas, it would be better to require the AER to demonstrate that it has sought to understand consumer preferences and their willingness to pay, rather than to require them to "assist" consumers to focus on what it, the AER, considers to be the key issues. Similarly, while asking the AER to produce annual benchmarking reports is useful, would it not be better to focus on ensuring that consumers are resourced to do this themselves?

In fairness to the AEMC, the arrangements for the empowerment of users in regulatory processes is an issue for policy makers not regulatory institutions. Genuine empowerment of consumers will inevitably change the roll that regulators play, and regulators can not be the decision-makers in proposing or evaluating fundamental changes in this area.