Major Energy Users Inc.

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Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

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Attention: Mr Ed Chan

2019 Economic Regulatory Framework Review
Response to Approach Paper
EPR0068

The Major Energy Users (MEU) is pleased to respond to the AEMC Approach Paper for its Economic Regulatory Framework Review. The MEU represents the interests of large electricity and gas users across the NEM and has been a consistent contributor to the deliberations of the AEMC over the years.

The MEU notes that the Approach Paper addresses three key areas, viz:

- Implement Finkel recommendation on network incentives
- Monitoring key trends and market developments
- Regulatory sandboxes

By and large, the MEU considers that the AEMC Approach Paper details the issues regarding each of these three topics well but the MEU considers that the AEMC has failed to include other more important elements of greater concern to consumer than those detailed in its approach paper.

These other more important issues are:

The regulatory asset base for energy transport

An overarching concern consumers have is that the Regulatory Asset Base (RAB) developed to move energy from sources to consumers has grown significantly in the past decade. By most measures, the RAB across the entire NEM has doubled in real relative terms when measured in terms of peak demand and in customer numbers. The imposition this massive growth places on consumers is very high and is a result of poor rule making and poor forecasting of peak demand in the past. This is exemplified by the utilisation of the assets in the NEM which show a near 50% reduction over the same decade.

The MEU has observed that there have been some changes to the rules in recent years, but this has not resulted in the RAB in real relative terms falling. The continuation of a high RAB into the future is placing excessive costs on both current and future consumers at a time when few consumers (whether residential or business) can afford for this to continue. The MEU is concerned that the AEMC is only proposing to “”play at the edges” of a massive cost impost rather than to address the substantive issue that the combined RAB is just way to high and utilisation of the assets is way too low.

Network revenues and low WACCs

The MEU notes that despite rates of return being at historical lows, the revenues achieved by networks seem to consistently increase, are static or show only marginal falls.

The MEU is very concerned that as rates of return move back to historical levels, the harm to future consumers will be massive. This highlights the MEU concern that the current regulatory regime does not reflect the needs of consumers

Incentives for networks

While the approach paper does indicate a need to address the incentives provided to networks, in addition to the incentive identified in the approach paper – that network investments are preferred by networks over non-network solutions – there are other incentives provided to the networks that on average have consistently returned revenues to the networks that exceed the regulators forecast revenues. That this is the case was revealed by the AER in its first release of data about network profitability[1].

The MEU considers that for incentives to be balanced, they should on average require consumers across all networks to not pay more, ie that bonuses should equal penalties.

The MEU also notes that networks are permitted to use the assets “paid for” by consumers but the revenue generated from such unregulated additional use is, by and large, retained by the networks. Yet if networks are fully reimbursed for providing the assets, then the additional revenue acquired from selling access to others should accrue to consumers.

[1] Return on Assets – Summary data- September 2018

While the MEU accepts that there needs to be an incentive for the networks to reduce costs for consumers, this should be limited to only part of the reward.

The MEU considers that the AEMC needs to include in its frameworks review, an improved approach to setting the incentives to provide better service rather than networks getting a bonus for just doing their job.

While the AER has argued that it's EBSS, CESS and STPIS schemes are balanced to not favour one incentive above another, this is not the case. For example

- The EBSS operates across regulatory periods yet the CESS operates within a regulatory period
- The STPIS provides an incentive to increase reliability yet consumers have long argued that they do not wish to pay more for increased reliability
- While the allowed capex is assessed and set independently of any other elements at each reset, the assumption is that the allowance is set at an efficient level. There is no ability to assess what is an efficient level for capex other than what is sought by the network. There is an underlying incentive for networks to overstate capex needs as
    - There is a financial incentive to use less capex than allowed
    - There is a financial disincentive not to exceed the capex allowance

  In contrast, opex is set based on a historically observed actual usage, which is then subject to benchmark comparisons

Flexibility given to networks

Too much flexibility is given to networks regarding the regulatory processes. Networks have unilateral control many of the inputs into the regulatory bargain, often use this power to the detriment of consumers. The MEU considers that greater consistency is needed in setting key parameters and which have a significant impact on the total cost to consumers.

For example, the range of expected lives for various assets used by networks varies considerably between networks, yet the actual differences in environments experienced between networks is relatively small. But the expected asset lives have two impacts on the final costs for consumers

- Assets will be depreciated differently with increasing costs for using shorter asset lives
- Using shorter assets lives has the potential to result in premature replacement of the assets
- Shorter asset lives allows networks to claim higher capex allowances and then by not replacing the assets, resulting in a bonus for under-running the capex allowance.

Similar flexibility is given in setting tariffs which may or may not result in providing financial incentives to consumers to moderate their usage patterns. For example, many tariffs have large fixed daily charges which provide a disincentive to consumers to reduce their usage.

Regularity Investment Test (RIT) process

The RIT is a cost benefit test which is controlled by the networks.

The MEU has noted that in recent RIT processes, the networks decide on the inputs to the development of the assumptions used to assess the benefits that will flow from the investment. Then the networks develop their own model to demonstrate the value of these benefits.

The first hand experiences of the MEU and its members is that getting access to detail of the inputs and assumptions to the model is difficult and access to the model itself is almost impossible. Yet without this access, much of the work of the networks can go unchallenged.

The MEU considers that conversion of the inputs and assumptions into the model and the development of the model itself needs to be carried out in a fully independent manner o the networks are not able to influence the outcome to suit their preferences.

Consumer involvement in the regulatory processes

There is an assumption made that consumers will be active in the regulatory processes, whether these are the AER processes for a reset, informed input to AEMO and AEMC processes or the processes used by networks which require consumer input. An example of these relative to the RIT process is the requirement for consumer engagement through the PSCR, PADR and PACR which are used to gain AER approval of the investment.

This assumption of informed consumer involvement is flawed in that to provide informed input requires funding. A review of the AER reset processes shows that consumer involvement in resets has fallen in recent years, consumers are expected to provide valuable consumer engagement with networks but this is limited as consumers have other priorities than providing free input to networks, especially when networks get recovery of their costs from the consumers that they are supposed to be getting input from. What is important to note is that in the RIT processes, detailed and informed input is required yet there is limited funding for this to occur.

Many of the recent changes to the rules relate to getting increased consumer involvement yet there is no recognition that this increased consumer involvement needs to be funded. Essentially, this makes the rules requiring consumer engagement toothless because consumers don't have the resources to provide the expected involvement.

When these other aspects are taken into consideration, it is clear that the three aspects proposed by the AEMC to be examined as part of the 2019 framework review, while having some value, they are not the aspects that need attention while there are more pressing issues that should be addressed in preference and which would deliver much better outcomes for consumers at a time when they are most needed.

The MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned at davidheadberry@bigpond.com or (03) 5962 3225

Yours faithfully

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