



Response to AEMC Network Rule Change

Contacts:

Mark Henley
Project Manager
UnitingCare Australia
08 8202 5135
0404067011
mark.henley@ucwesleyadelaide.org.au

Susan Helyar
National Director
UnitingCare Australia
02 6249 6717
susan@nat.unitingcare.org.au

The National Body for Community Services in the Uniting Church
supporting service delivery and advocacy for children, young people, families, people with disabilities and older people

Section 1 Introduction

Uniting Care Australia welcomes this opportunity to respond to a rule change proposal that we regard as one of the most important since the establishment of the NEM. This rule change has considerable impact in small consumers, particularly low income and vulnerable consumers across the entire NEM.

The following story aims to provide an individual consumer context to the major and complex task at hand in assessing the rule change proposals. Failure to take the sort of action proposed by the proponents will add to the existing energy stress being experienced by, literally, millions of citizens.

Mike is nearing retirement age and works part-time as an afterhours caretaker. Both Mike and his wife are proud of the fact that they have paid off her own home, have modest savings for retirement and have done everything that they can keep the energy and water efficient. "I spent a small fortune on energy efficient light globes when they first became available", says Mike, "and they have no doubt reduced our energy use a little bit, but the bills keep going up."

These days, Mike and his wife dread the arrival of their utility bills, both because the bills are more expensive each time no matter how little energy they use, and also because the stress of not being able to pay, on time, is uncomfortable for them.

"For the first time in our lives, we had to ask for extensions to pay our electricity bills last year, and now we are having to use some of our limited savings to be able to pay our bills, and this is after we have done everything we can, to be energy efficient" says Mike, in frustration.

Their most recent gas bill was a modest \$80.00, but what frustrates them is that nearly \$60 of that was for the supply charge, which Mike does not regard as fair or reasonable – "we must have bought half the network over the past 40 years" suggests Mike. The most recent electricity bill, after a mild summer in Adelaide, was \$397.00, nearly double what it was three years ago, and with lower use.

"We are really worried that we just won't be able to afford to pay an energy and water bills once we retire - already we are having to use our savings just keep head above water" says Mike.

About Uniting Care Australia

UnitingCare Australia is an agency of the National Assembly of the Uniting Church in Australia. We represent the Uniting Church's network of community services of which there are over 1,300 service delivery sites nationwide.

The UnitingCare network is one of the largest providers of community services in Australia, providing services and supports to more than 2 million Australians each year, employing 35,000 staff and 24,000 volunteers. We provide services to older Australians, children, young people and families, Indigenous Australians, people with disabilities, the poor and disadvantaged, people from culturally diverse backgrounds and older Australians in urban, rural and remote communities.

UnitingCare Australia works with and on behalf of the UnitingCare network to advocate for policies and programs that will improve people's quality of life. UnitingCare Australia is committed to speaking with and on behalf of those people who are the most vulnerable and disadvantaged, for the common good.

UnitingCare Australia believes that all people have the right to access a decent standard of living. This includes access to:

- appropriate food, clothing, housing and health care;
- meaningful work, education, rest and recreation;
- the opportunity to meaningfully express and explore spiritual needs; and
- the opportunity to participate in and contribute to communities.

UnitingCare Australia believes that belonging in community is fundamental to people's well being. UnitingCare Australia values an inclusive community that strives to remove all barriers that prevent people from belonging and participating as fully as they wish and are able.

The values that Uniting Care agencies hold as important and that play a role in informing our responses to this public policy set of questions include:

1. commitment to the common good and indeed our belief that government policy and community programs and citizen engagement need to put a commitment to the community or the common good ahead of individual gain
2. equity matters, the more unequal our society is, the more citizens who are excluded from participating in society, the more quickly that society experiences problems.
3. Stewardship of our environment is a fundamental responsibility of societies both in the short-term and for the benefit of future generations. We strongly support the notion of the triple bottom line for government community and business organisations whereby economic stewardship, environmental stewardship and the nurture of citizens (social stewardship) are equally valued and reported on publicly.

Our response to the network rule change directions paper is in two sections:

1. Energy affordability for residential consumers, social services and small business
2. Response to key elements of the rule change, based on the directions paper

We emphasise that energy is an essential service of crucial importance to citizens, providing direct benefits to the individual as well as a range of positive externalities that afford better health and well-being for citizens as individuals and communities as a whole. Energy, for example, is a critical element in the provision of water and sewerage systems both of which have considerable public health benefits for the community. Energy in homes and commercial settings helps to preserve food and provide a sound basis for cooking thereby helping to reduce disease. Energy is also crucial in washing and cleaning at domestic institutional and commercial level, also delivering considerable community wide public health benefits.

We cannot overstate the importance of this rule change, in a period of ongoing, substantial energy price rises.

Section 2 Affordability

There can be little doubt that for most Australians, far and away the most important energy related issue is affordability of energy, particularly electricity, for which there is no direct substitute. This section therefore explores our perspectives about electricity affordability in the current context, 2012, we intend it as evidence for some of our comments in the next section, dealing specifically with the rule change proposal.

We also assert that the long term interest of consumers, the priority for energy policy as stated in the national electricity and gas objectives, cannot be met if citizens cannot afford the energy that they need now.

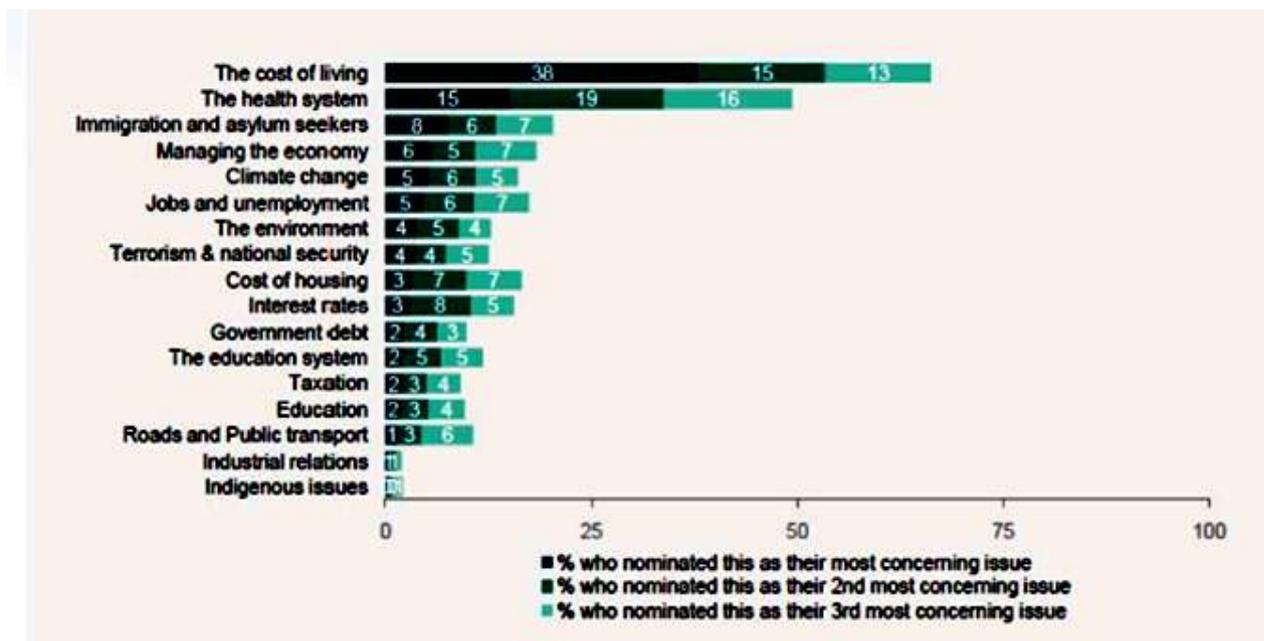
The main interest of the Uniting Care network is in the domestic energy services arena of energy policy and practice. This section is then the basis of our focus for the remainder of this submission. We now consider the primary consumer interest concern about domestic energy supply; affordability. We believe that it is this issue and impacts on lower, modest and increasingly middle income households that provides that context and the imperative for energy policy and regulation in Australia, at the moment.

Cost of Living Concerns

The following graph, graph 1, reproduces data collected from a survey conducted for the Clean Energy Council, asking Australians what is their issue of most concern at the moment. Very clearly the cost of living is dominating concerns of Australian citizens at the moment, followed by the health system.

Many other debates receiving considerable media coverage currently, rate at very low levels of interest to citizens in comparison to cost of living concerns.

Issues of concern for Australians, 2011

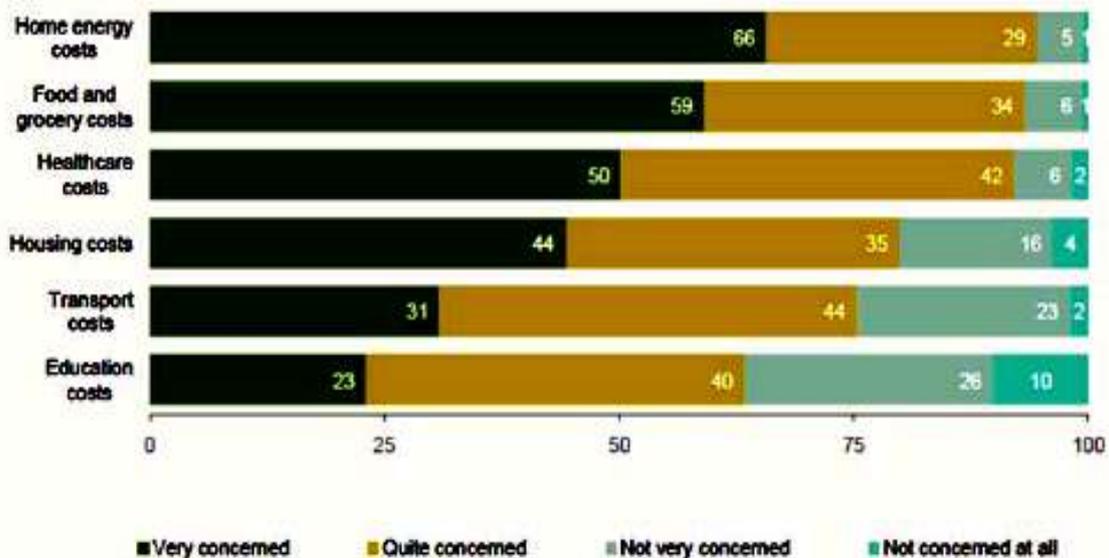


Graph 1: Source: Clean Energy Council of Australia

The data shows that 66% of respondents identified cost of living as one of their three issues of greatest concern, with 38% nominating it as their greatest concern, more than double the number of people than the second issue. The graph shows that no other issue is anywhere near the concern expressed about cost of living and the health system.

Central to cost of living concerns are deep concerns about high energy costs, with two thirds of Australians being 'very concerned' about high energy costs, followed by food and grocery costs and health care costs as shown in the second graph below.

Cost of Living Concerns 2011



Graph 2; Source: Clean Energy Council of Australia

Graph 3 shows the Retail Electricity Price Index from 1991-2010 for Australian capital cities and is taken from the AER state of the market report published in 2010. What this data shows is that residential electricity prices have risen considerably over the last three to four years in all jurisdictions. South Australia clearly experienced a major increase in prices for residential consumers of 25-30% per customer when the South Australian market moved from state ownership to full retail contestability in 2003/4. While prices fluctuated with low trend increases from 1991 – 2003, the net price increases in all jurisdictions have been significant over the last decade.

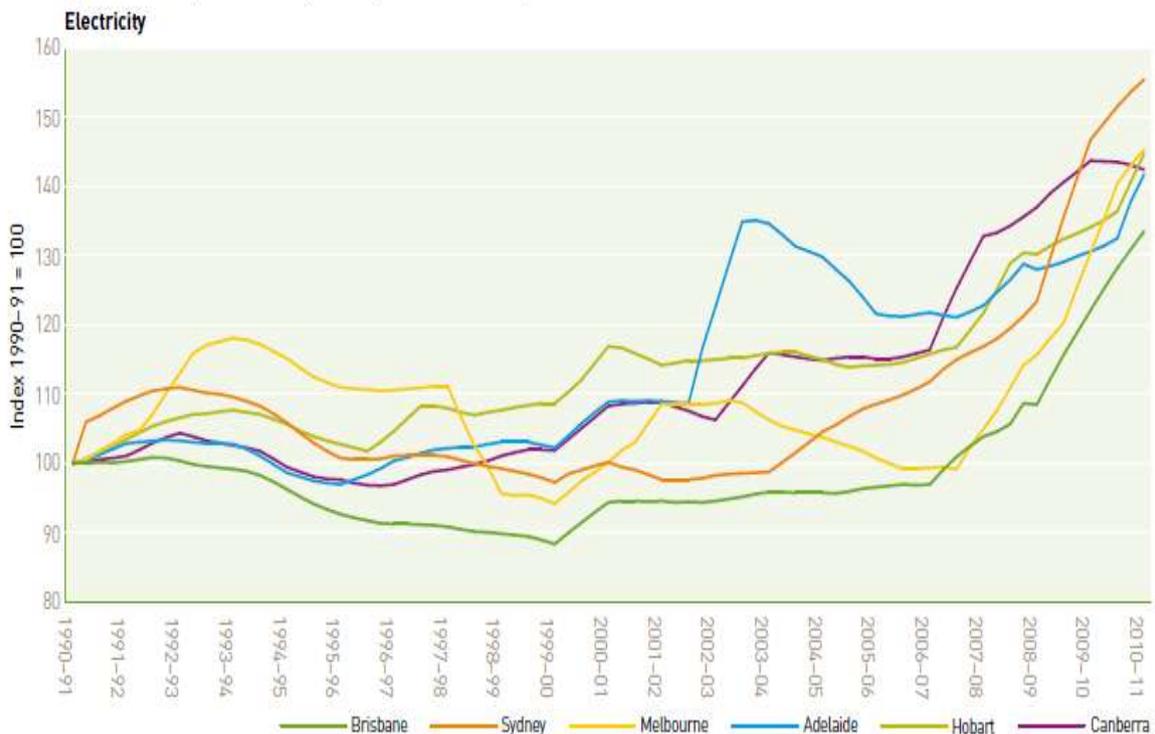
Observation 1

Cost of living is the issues of most concern to Australian citizens at the moment and home energy costs – electricity and gas – are the cost of living pressure of greatest concern

Eleni
Eleni is a 70 + year old Greek lady who has difficulties with English, has been living in the same house for over 40 years, and was worried about her increasing energy bills. Her son who lives with her and is on a DSP is continually buying/hoarding electrical appliances. She pays her bill at the Post Office being resistant to using Centrepay and is very worried about the rising cost of electricity.

Retail Electricity price Index

Retail price index (inflation adjusted), Australian capital cities



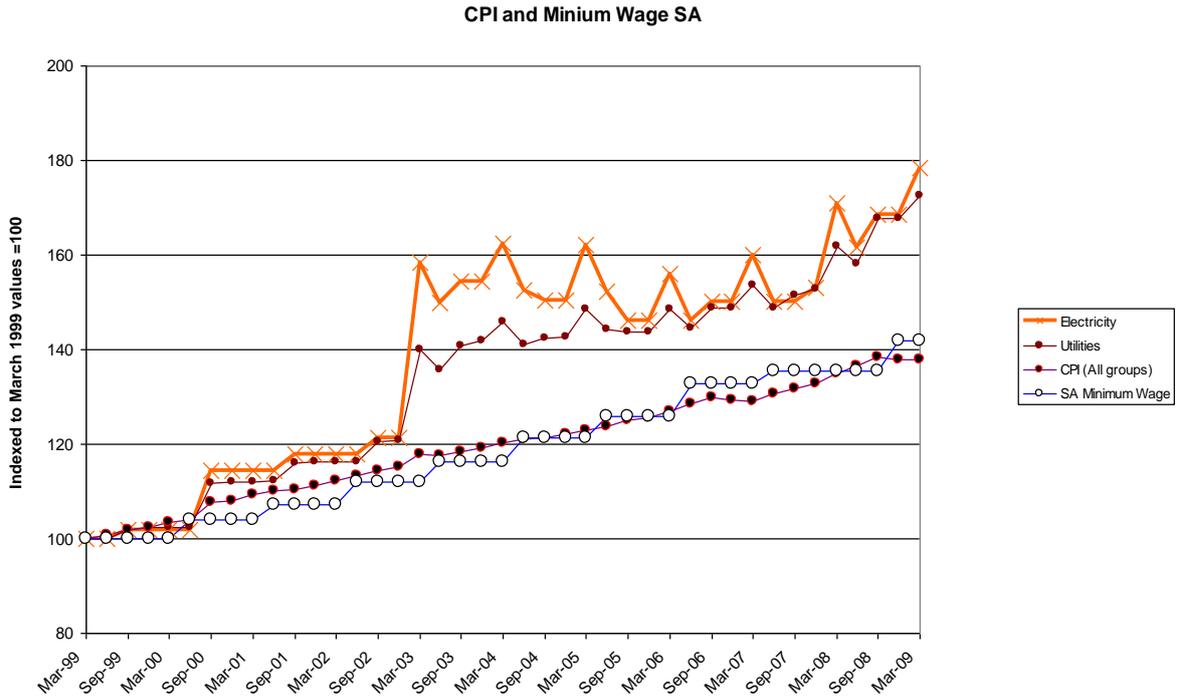
Graph 3: Source: AER State of the Market report 2011

Graph 4 shows the South Australian situation, as an example, comparing changes in electricity costs and utility charges overall with CPI and South Australian minimum wages, using an index with 1999 figures set at 100. It is clearly evident that the price of electricity and utilities has gone up at a dramatically faster rate than CPI and minimum wages since 2003, with a steady rise since 2007, after some stabilisation from the dramatic price rise of 2003. This significant gap between CPI, real wages and, we suggest, revenue for many small businesses, has increased the cost of electricity, compared to other costs, for small consumers. This no doubt is why consumers are so concerned about energy prices. We also suggest that the global financial crisis, commencing in 2008, has had the impact of reduced hours for many lower income workers, so while energy prices keep rising, household incomes for many households actually fell, further exacerbating the gap between energy prices and household incomes.

Observation 2

Standing energy costs are rising much more rapidly than CPI and minimum wages

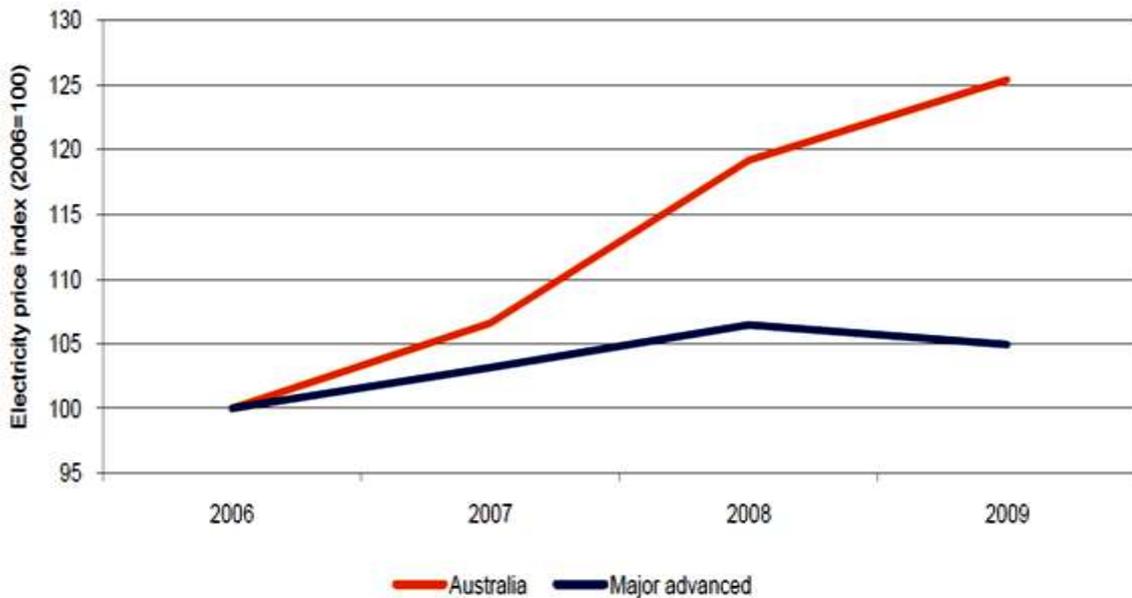
Electricity prices in Australia have grown at a much faster rate than other OECD nations since 2006, a factor that has exacerbated energy affordability problems for growing numbers of small consumers.



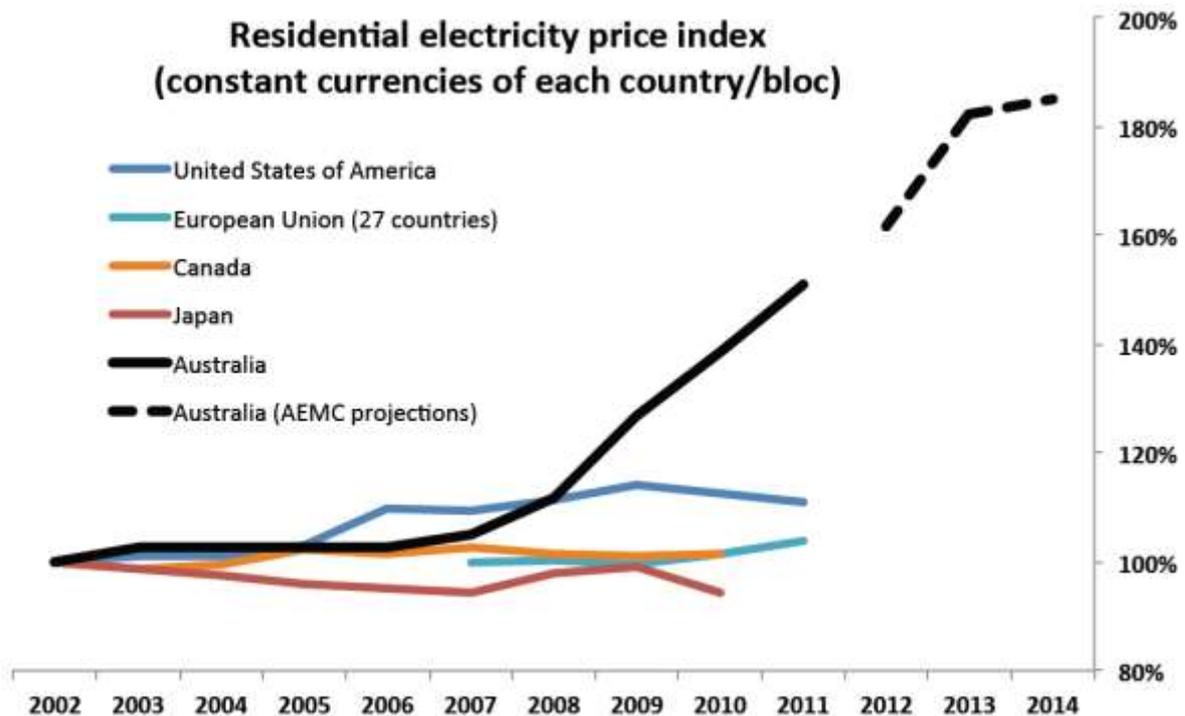
Graph 4: Source ABS, CPI

Graph 5, then compares Australian electricity prices in aggregate, as an index, compared with other OECD economies. Electricity prices in Australia have grown much more dramatically than for comparable countries over the last 5 years. Graph 6 provides some further detail, and includes projected Australian electricity costs for the years 1012 – 14.

Real Electricity Prices Australia and the 7 Major economies, 2006-9, indexed to \$US



Graph 5: Source IEA, 2009, OECD 2010

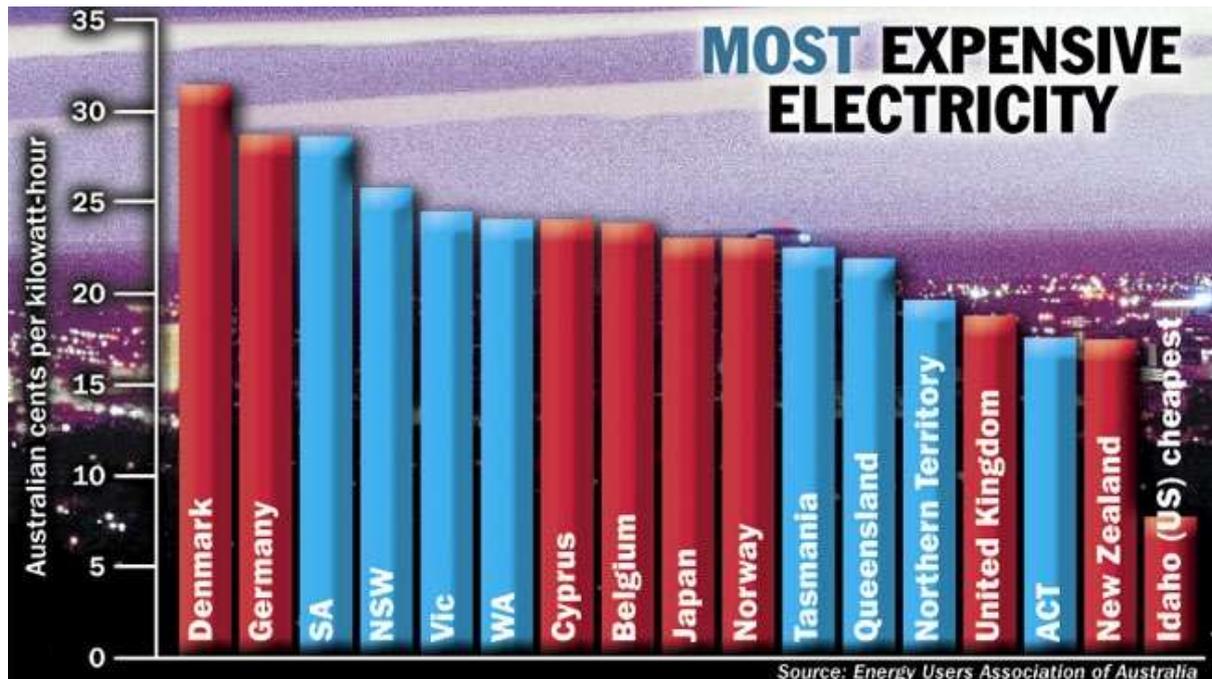


Graph 6 Source: Carbon Markets

This graph shows that since 2007-8, when Australia and comparable nations had reasonably similar electricity prices, Australian residential electricity prices have grown rapidly while prices in countries with comparable economic development, prices have remained steady, or fallen, as in Japan the United States of America. Modest projections for Australian prices through to 2014 indicate continued and rapid growth in prices, almost certainly more dramatic increases than in comparable nations.

This situation has been put in context recently by the Adelaide Advertiser on 21st March 2012, which said “South Australia's power prices set to become highest in world says Energy Users Association of Australia”. Graph 7, below was printed by the Advertiser as part of their evidence for the ‘highest electricity prices in the world’ claim. The Advertiser also wrote “South Australia will have the world's most expensive electricity as soon as July this year, energy experts predict. A report released today by the Energy Users Association of Australia, which compares 2011 household electricity prices in 92 countries, states or provinces, shows South Australian prices are the third highest behind Denmark and Germany.”

Graph 3, an index for price changes, shows that over recent years, prices in Sydney, Melbourne, Hobart and Canberra have all grown at a faster rate than for Adelaide. South Australia started that period indexed in Graph 3, with higher prices than other capitals, which is why it remains the State / Territory with the highest prices, but the rest of Australia is catching up, graph 7 shows NSW, Victoria and Western Australia immediately below South Australia on the global energy costs graph, with remaining Australian Jurisdictions close behind. So if South Australia does have the highest residential electricity costs in the World, in the near future. The rest of Australia will also be close to the most expensive electricity in the world too.



Graph 7, Source Adelaide Advertiser, 21/3/2012¹

Observation 3

Australia has some of the highest residential electricity prices in the world

Another critical factor in considering the incidence of electricity prices is shown in the following graph which is taken from the 2003-2004 household expenditure survey from the ABS and shows the percentage of household income spent on electricity by income quintile and compares that with average use per household from each (equivalised household) income quintile.

Ruby

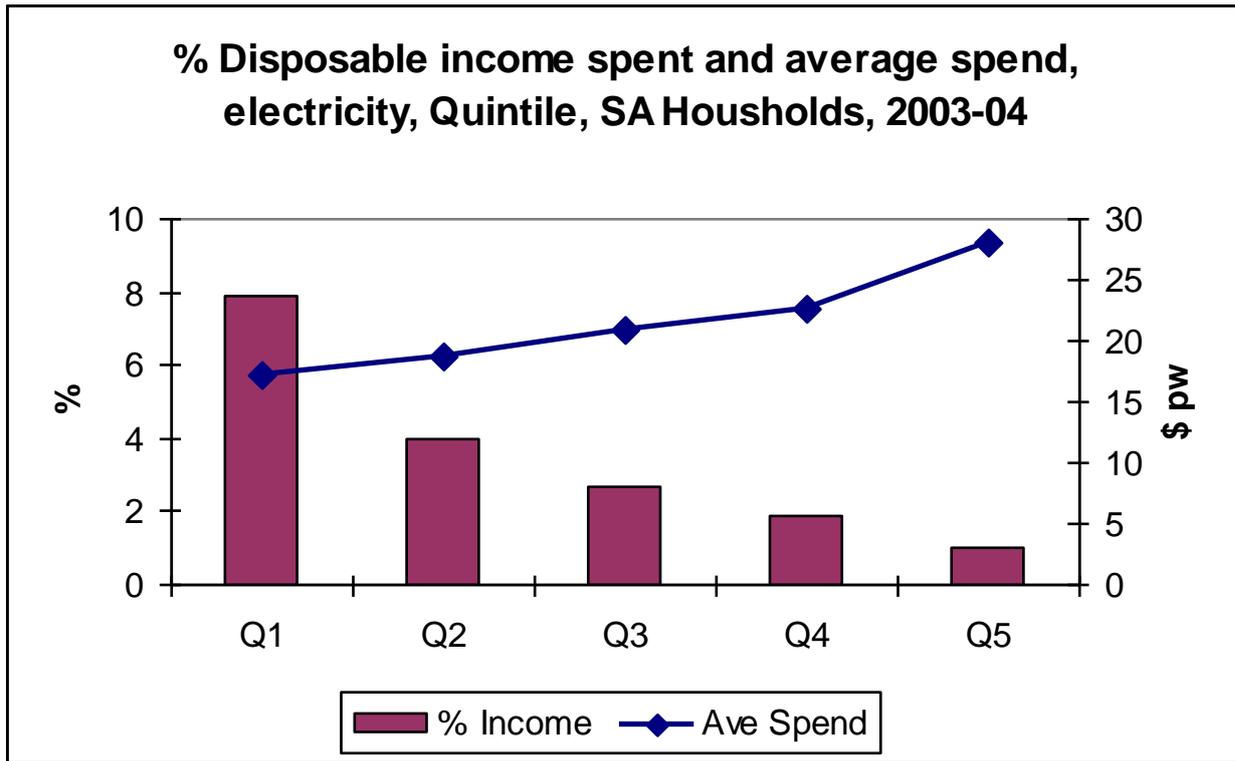
Ruby is a single mother with two young children, she lives near Port Pirie in South Australia. Last year, the bills got on top of her and she made the difficult decision to go and see a financial counsellor. She took her bills with her and was in tears when she asked the financial counsellor what he could possibly do to survive.

Ruby got behind with her electricity bill, and had a carried forward debt, she had contacted her electricity retailer for help and had been told that she had to repay some of the debt with every bill that she received, and having no choice, she agreed.

The financial counsellor recognised that Ruby's carried forward debt was just over thousand dollars, and that her electricity bills were over 15% of her available income, on top of 30% of income for rent. The financial counsellor calculated that the repayment schedule that the energy retailer had given required Ruby to pay a total of \$3,100 on top of her normal use, over the period for repayment.

"How can I afford to buy food for my kids?" asks Ruby.

¹ <http://www.adelaidenow.com.au/news/south-australia/power-prices-to-be-highest-in-the-world/story-e6frea83-1226305741810>



Graph 8: source: ABS, household expenditure Survey 2003-4

Graph 8 clearly shows that low income people pay a dramatically higher proportion of their income on electricity, despite being the lowest users of electricity, on average.

This is a particularly important factor to consider when dealing with any circumstance with the potential of increasing the cost of electricity.

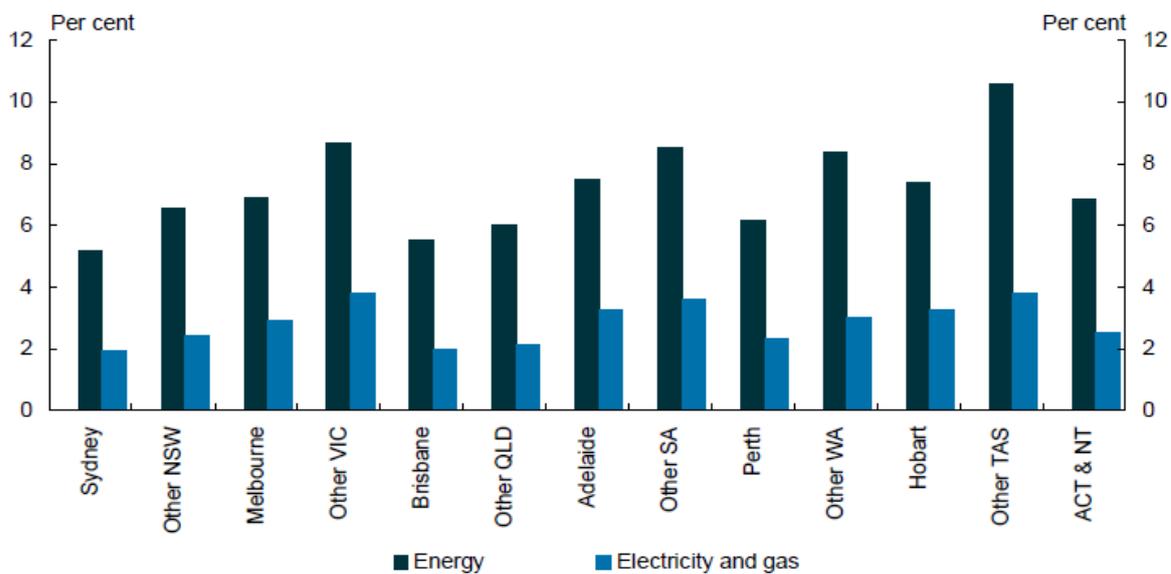
It is crucial to consider distribution of impacts of energy markets, rather than using averages as a basis of policy. For example, the ABS Household Expenditure Survey (HES), 2009-10, reports, accurately, that average household expenditure on domestic fuel and power is 2.6% of total goods and services expenditure.² This is sometimes reported as indicating that energy costs are cheap and affordable in Australia. However, such reporting fails to recognise the distribution impacts of energy costs, with large number of lower and modest income households spending well over double the average household energy cost. This is compatible with the HES data dealing with financial stress, which shows that 12.55% of all households struggle to pay utility bills on time with 17.9% of poorest quintile households unable to pay on time 16% of second and third decile households experiencing this financial stress.

Energy bills are highly regressive, impacting much more heavily on lower and modest income earners, than higher income users. This reality needs to be taken into account when consideration is given to network wide spending that is smeared across all users. So increasing reliability in a capital city CBD, for example, is paid for, in part, by lower income residential and small business customers in outer suburban, regional and rural locations, who receive no benefit from CBD network enhancement.

² Household Expenditure Survey 2009-10, cat no 6530.0, ABS, September 2011

Geography also plays a significant part in the distributional impacts of energy costs. Graph 9, below, reproduces data from the Australian Treasury’s Low Carbon Future reporting. It shows that spending on energy, including standing energy is significantly higher in non metropolitan locations around Australia. The data reported is averages for the various categories of households, so applying the comments above about distribution impacts based on household income, we can conclude that lower and modest income households in rural and regional locations will be bearing a dramatically greater energy cost burden than higher income households based in capital cities.

Chart 3.42: Spending on energy as a percentage of all spending 2010-11



Graph 9: Source Treasury, Australia’s Low Pollution Future The Economics of Climate Change Mitigation, 2008

Observation 4

Electricity pricing is highly regressive, with low and modest income consumers bearing a dis-proportionately high cost as a proportion of income

Observation 5

Distributional impacts of energy pricing and other policy impacts must be given high credence than averages as measures of policy impacts on consumers

Observation 6

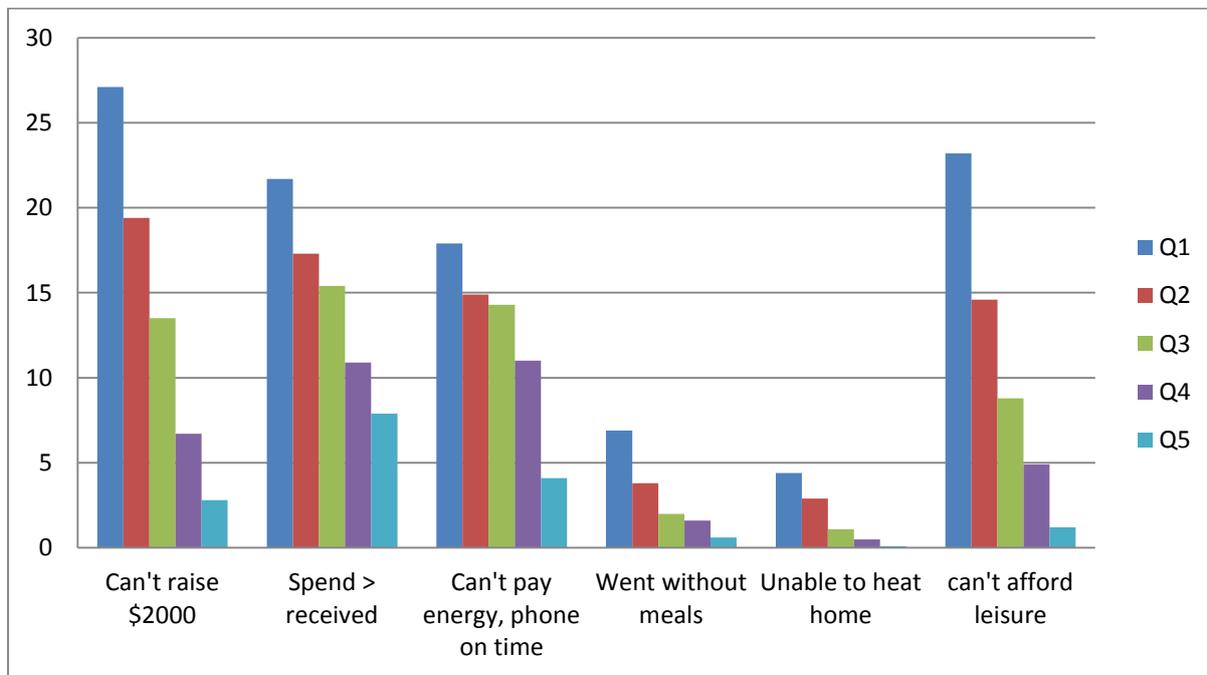
Energy Costs are considerably higher in rural and regional locations

Zahra
 Zahra is a proud African woman with 5 daughters, the two eldest being at university, she is very proud of her girls and the opportunities they have in Australia. Her husband was killed in her homeland, a reason for coming to Australia as a refugee.
 “We all share a small house , we all work hard and we get by, but with only my income, it’s the electricity bills that I dread the most,” she says.

Household Financial Stress

We now ask what does the impact of rising electricity prices look like for residential consumers? The following graph taken from the ABS household expenditure survey, released in 2011, shows various indicators of household financial stress against equivalised household income quintiles.

Indicators of Household Financial Stress



Graph 10: Source ABS Household expenditure Survey 2011

It is noted that inability to pay energy and other utility bills on time is of major concern for all quintiles, for the poorest quintile households about 18% reporting inability to pay bills on time. However, second and third quintiles are at about 14% inability to pay bills on time and even the fourth quintile of income distribution reports over 11% of that relatively high income group struggling to pay energy bills, in particular, on time.

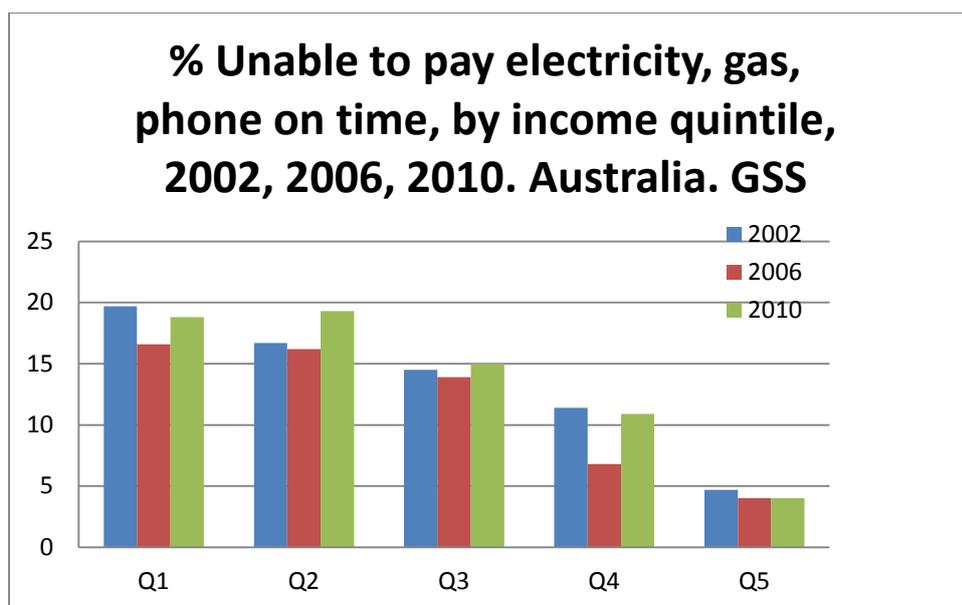
Robbie

Robbie has lived on the northern New South Wales coast for all of his life, now in his 30's he is well known to the local community, and everyone loves his infectious energy, up beat personality and sense of humour.

Robbie has had a disability for all his life, being dependent on others, particularly his parents and close family. So it was a day of great excitement when Robbie moved into his new independent unit, having his own space while sharing a facility with other people he had known from much of his life. The generosity of the local community came to the fore with donations and gifts of everything that Robbie could possibly need in his own unit. – even 2 fridges.

Support workers spent considerable time with Robbie explaining the need for him to pay his own bills which meant managing his own money, and using electricity when he really needed to. Hours were spent on budgeting which included the cost of running various appliances.

Robbie's first electricity bill was over \$1600 for the quarter. "How can I ever pay this?" asked Robbie.



Graph 11: Source ABS, General Social Survey

Graph 11 shows data from the ABS, General Social Survey (GSS) , for the years 2002. 2006 and 2010, for ability to pay utility bills on time, by income quintile. We highlight that levels of inability to pay these bills rose for all quintiles, except highest income, between 2006 and 2010. The percentage increase in inability to pay bills, over the 4 years 2006-2010 for each quintile is”

Income Quintile	% change in Households unable to pay on time, 2006-10
Q1	13%
Q2	19%
Q3	8%
Q4	60%
Q5	No change

Table 1: Source ABS, General Social Survey

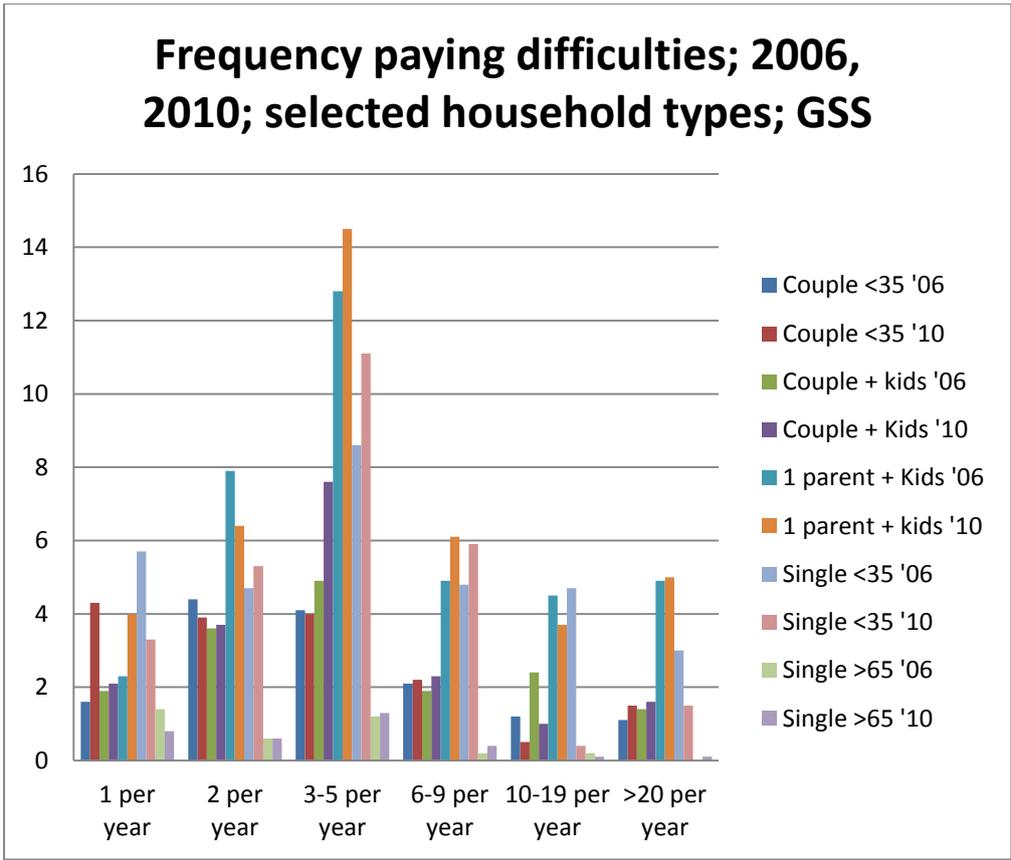
For Uniting Care Australia the alarming reality of utility price increases is the move from affordability being a predominantly low income household issue, to it also being a problem for middle and higher income households. The 19% increase for households in the second quintile, along with the 13% increase in the first quintile shows the pressure that lower and modest income households experience in paying their bills. That there has been a 60% increase in inability to pay bills on time for fourth quintile households shows how deeply utility prices are biting into budgets across the household income distribution.

Margaret

Margaret came into a Hobart financial counselling agency with large unpaid electricity and gas supply accounts. Her electricity usage was high during winter months due to inefficient and costly heating methods. Margaret said that she was separated from her husband, had three dependent children, and received income support payments with occasional periods of casual employment. She previously had a payment plan in place with her energy supplier but this had lapsed due to insufficient income. Disconnection of supply was threatened.

The counsellor arranged for a new payment plan with the electricity supplier and a benevolent institution was approached to make a one off payment of the outstanding gas account. The counsellor arranged for the client to receive information on electricity consumption saving and concessions not previously claimed were identified.

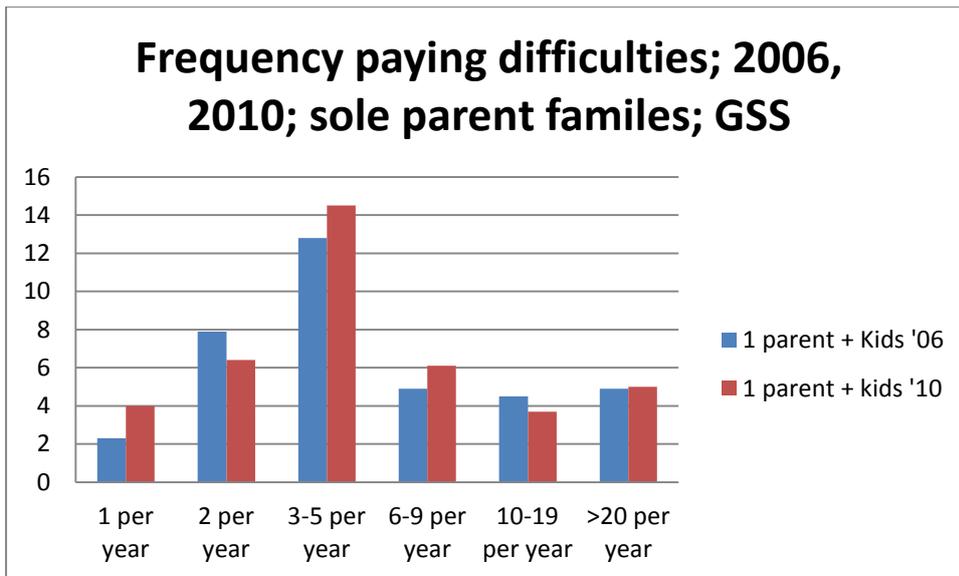
A budget plan was prepared and the client was urged to make full use of casual employment opportunities identified. Margaret says that she is coping a bit better now, but still worries about her next electricity bill.



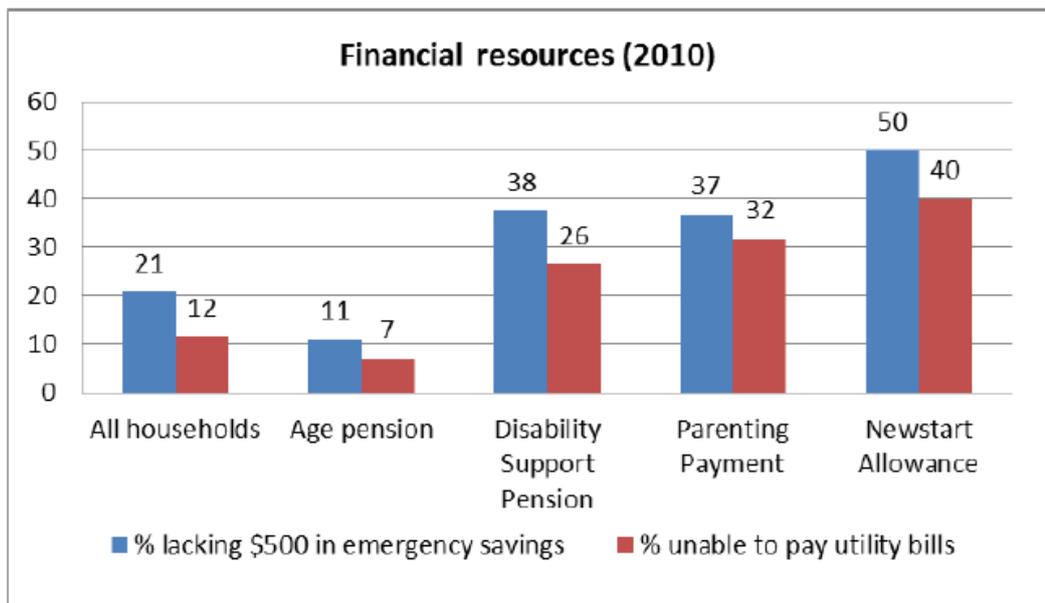
Graph 12: Source ABS, General Social Survey

Graph 12 shows frequency of payment difficulties for various household types for 2006 and 2010, with the unit of measurement for the Y-axis being percentage of households.

The first observation we make from this data is that the modal score for each household type and for both years was a frequency of 3-5 episodes of payment difficulties per year. So that households that experience payment difficulties during a year, are likely to have multiple experiences of payment problems. It is also clear that sole parents with children are the household type that experiences the greatest level of payment difficulties in each frequency category. They are also the household category most likely to experience a large number of payment difficulties over a year. In 2010, 5% of sole parent households reported more than 20 episodes of payment difficulties, which is nearly a payment difficulty every fortnight, suggesting chronic financial stress. The experiences of sole parents is presented in graph 13



Graph 13: Source ABS, General Social Survey



Source: PEMA survey, Saunders & Wong (forthcoming).

Graph 14: Source Poverty and Exclusion in Modern Australia (PEMA) survey, Social Policy Research Centre

Graph 14, from a forthcoming publication from the Social Policy research Centre shows two measures of financial stress in 2010, for households with various pension and allowance payments as their primary source of income. The data is both a reflection of the inadequacy of current allowances, and of the extent of payment difficulties for utility bills, with 40% of Newstart Allowance recipients unable to pay bills and over a quarter of Disability Support Pension recipients in the same situation.

Observation 7

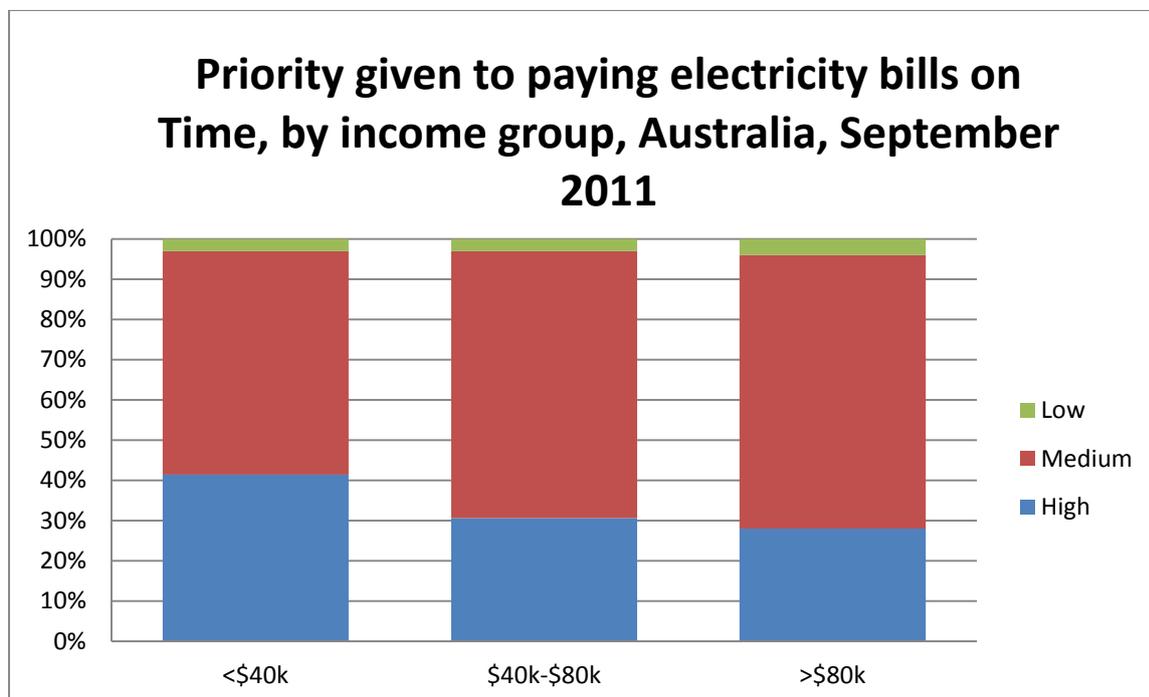
A vast majority of households who are unable to pay utility bills will experience multiple episodes of payment difficulties during a year

Observation 8

People reliant on government allowances, specifically Sole parents, people receiving the Disability Support Pension and unemployed people receiving the Newstart allowance are most likely to experience difficulties in paying their utility bills, including energy bills

Impacts on households

Uniting Care Australia has undertaken some surveying to consider the impact on households of rising electricity costs and to test some assumptions that are sometimes presented as fact. A couple of years ago and earlier, we regularly heard complaints from retailers, that residential consumers who didn't pay their bills on time were "won't payers" rather than "can't payers" and that households were seemingly giving lower priority to paying energy bills on time. So we have tested these views by asking residential customers from across Australia, the priority that they gave to paying energy bills on time, using a sample of about 1300 people.



Graph 15: Source, Uniting Care Australia survey, September 2011

The results shown in Graph 15 show that lower income households, we have determined household income below \$40,000 pa as our benchmark for low income, placed the highest priority on paying electricity bills on time, compared to medium and higher income households. We also observe that energy retailers are generally accepting of this finding and are now much less likely to talk about "won't payers", and we respect their willingness to better understand the payment difficulties that their customers are experiencing.

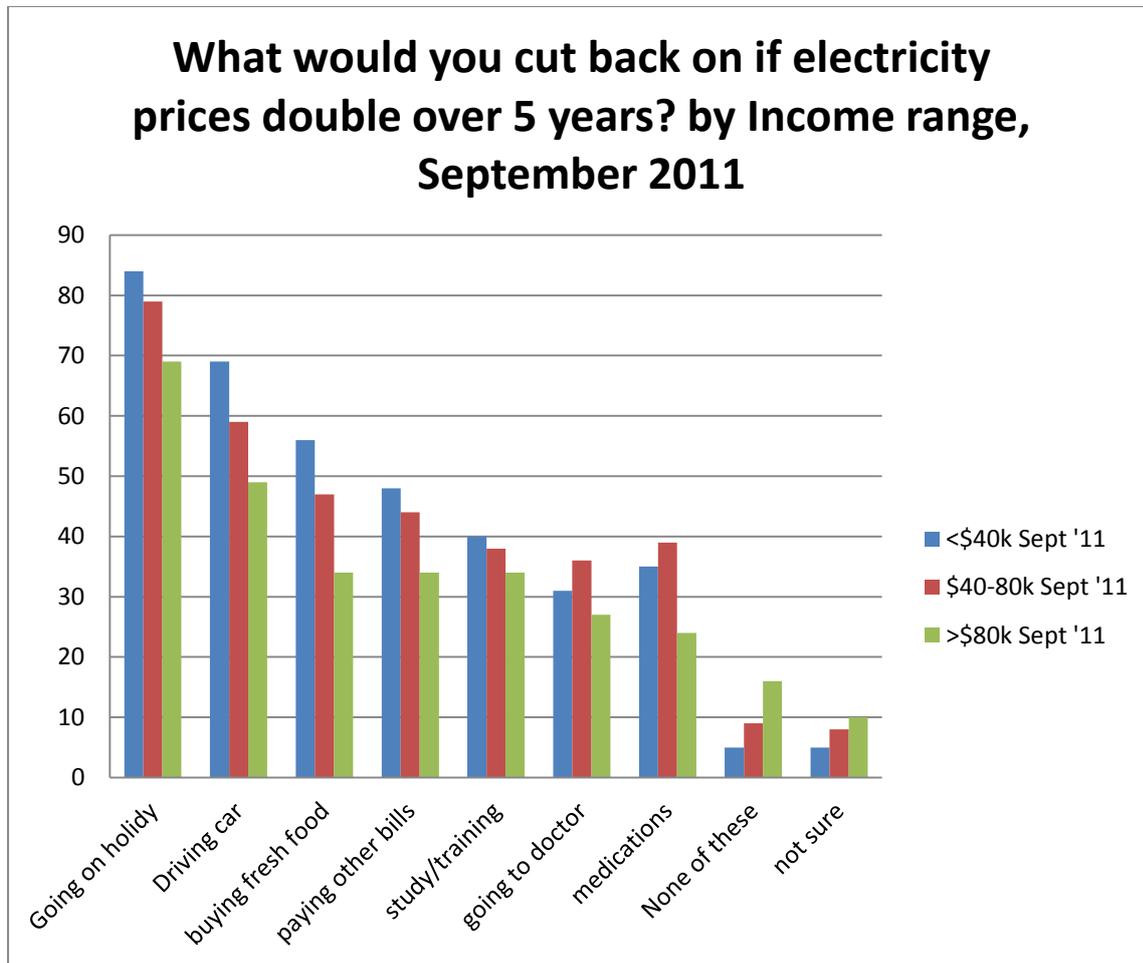
Observation 9

All households, particularly lower income people put a high priority on paying energy bills on time.

We have also asked the question "if electricity prices doubled over the next 5 years, then what will be the impact on spending on various other parts of your household budget?" Results are given in graph 16 and are given for 3 income levels, households with less than

\$40,000 per year (low), \$40,000 - \$80,000 per year (medium) and over \$80,000 per year (high). We believe that the proposition that electricity prices could double over the next 5-6 years to be reasonable, it is a notion that has had recent media coverage, for example “The recent media hype about moves by the Australian Energy Regulator to 'slash power bills' is at odds with new analysis suggesting that electricity prices may double between 2011 and 2017,” was written by Keith Orchison in the Business Spectator, October 3rd 2011.³ On May 22nd last year, the Herald Sun reported similar projections from TRU Energy.⁴ Uniting Care agencies report that many clients are reliant on casual work, with declining hours of work and wage rates that barely keep up with inflation, so nominal price increases are likely to be very close to real increases for lower and modest income households.

**Likely Impact on spending of a doubling in electricity prices, over 5 years
Australia, September 2011, n = 1300**



Graph 16. Source: Survey conducted for Uniting Care Australia, by The Australia Institute

Of considerable concern is that about half of households with incomes of less than \$80k per year, a majority of Australian Households, have indicated that they would struggle to pay other bills if electricity prices increased, while nearly 40% of lower income households and

³ <http://www.businessspectator.com.au/bs.nsf/Article/energy-costs-power-bill-Australian-Energy-Regulator-20111003-M9URP?OpenDocument&src=rot>

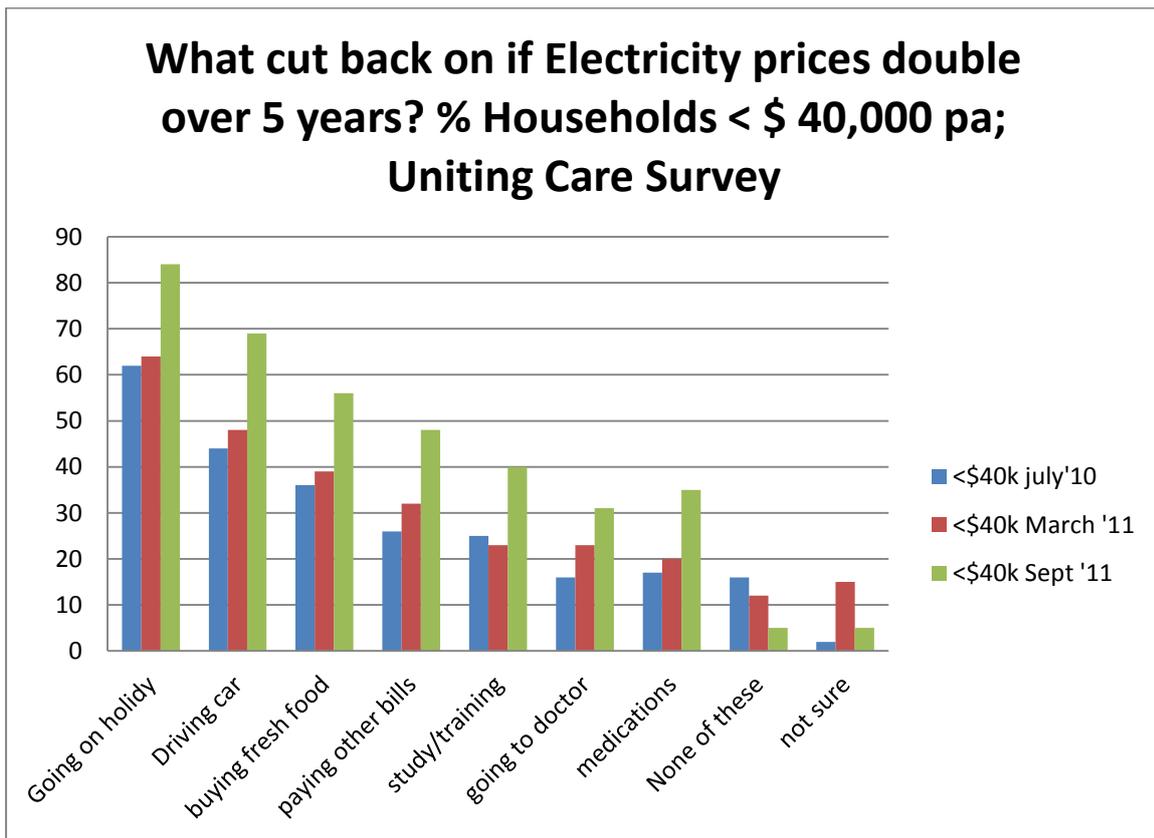
⁴ <http://www.heraldsun.com.au/archives/old-news-pages/power-bills-to-double-in-six-years-on-carbon-price-truenergy/story-e6frf7ko-1226060533782>

about half of middle income households (our definition of \$40-80k per year household income as middle income) would reduce their spending on fresh food. Another major concern is that about 30% of households across the entire survey of about 1300 sample size, said they would go without medicines or visits to the doctor, with major electricity price increases, so there are adverse health impacts of rising energy costs.

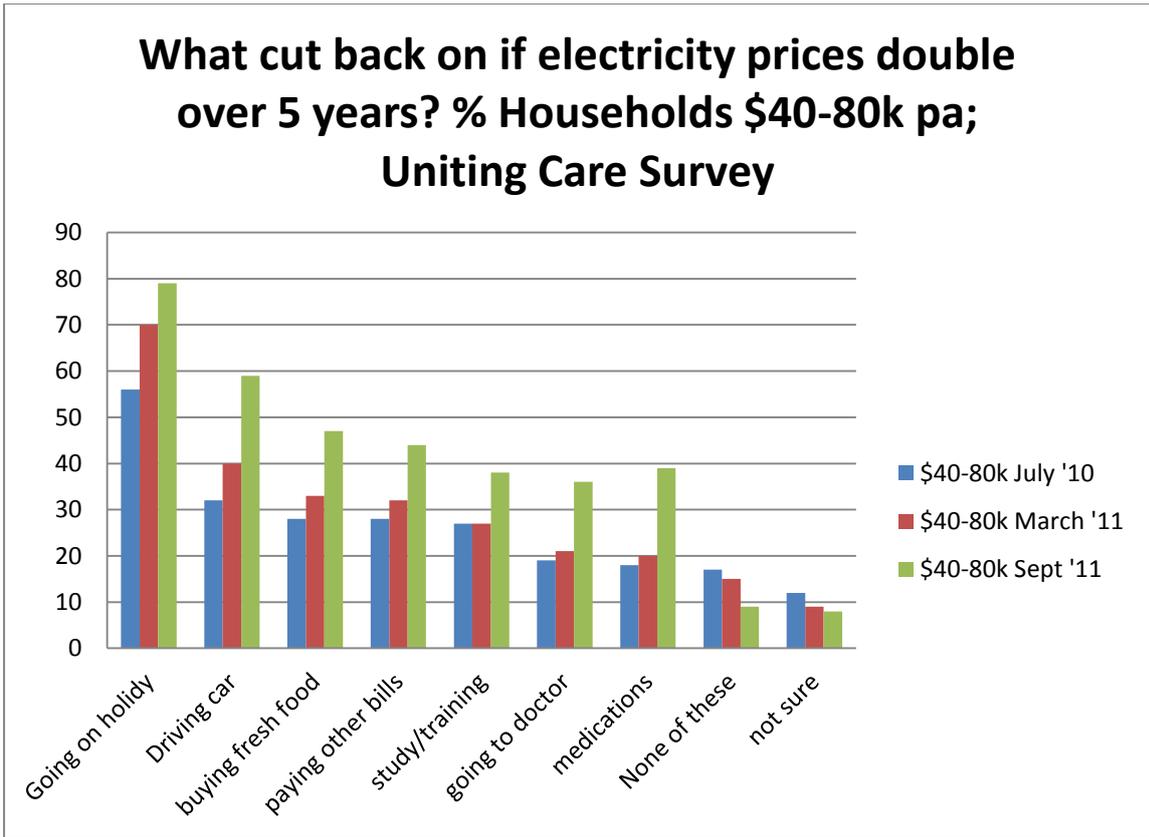
Nearly a third of people surveyed, across all incomes also indicated that they would reduce spending on study and training. This has substantial economic implications. If rising living costs, including energy costs are reducing spending on skills, then the productivity and indeed employment growth, so central to overall economic growth are hindered. Another implication is that if lower income households are less able to gain skills for employment, then they are further excluded from economic opportunity, extending divisions in our two speed economy.

Uniting Care Australia was surprised by the relative similarity of responses across income groups, confirming that energy affordability is a concern that is community wide.

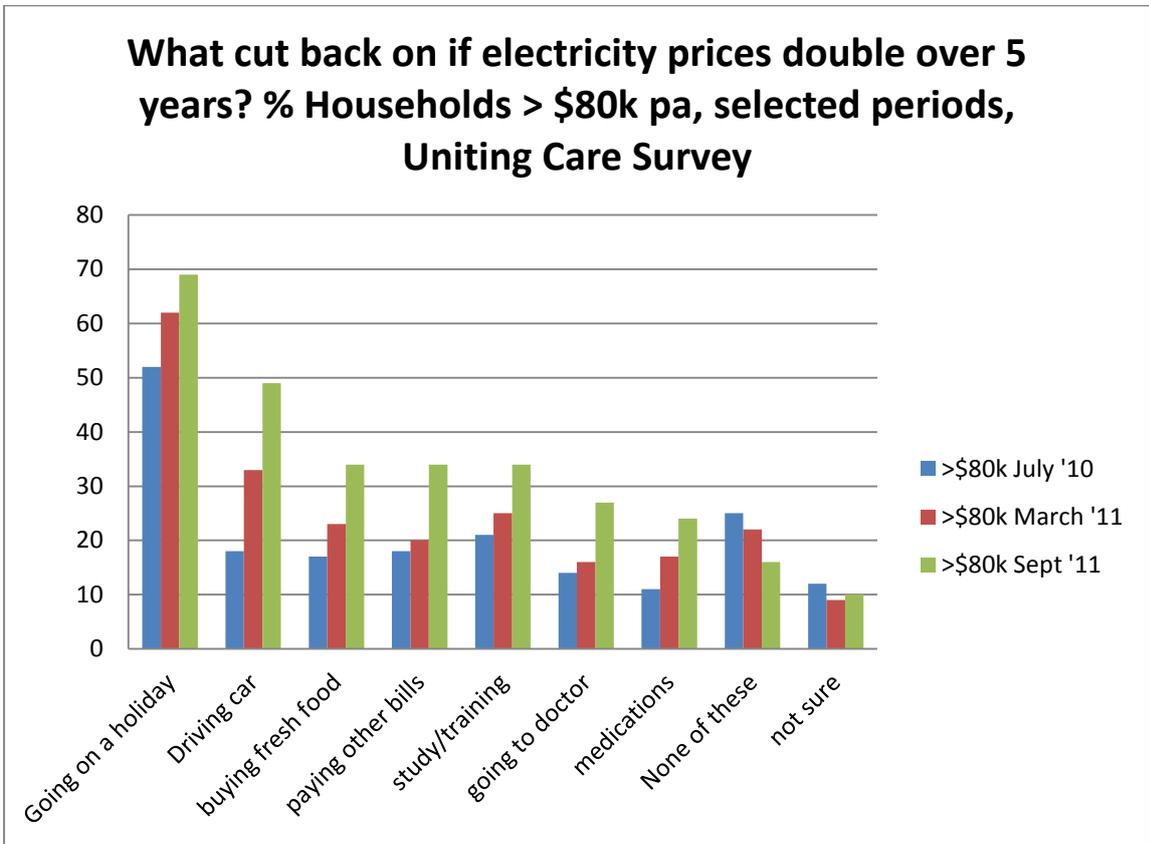
The following three graphs present the responses to the question of impacts on households of electricity prices doubling over the next 5 years, according to household income. The survey has been conducted 3 times, July 2010, March 2011 and September 2011. Each graph presents results from each of these 3 surveys.



Graph 17. Source: Survey conducted for Uniting Care Australia, by The Australia Institute.



Graph 18. Source: Survey conducted for Uniting Care Australia, by The Australia Institute



Graph 19. Source: Survey conducted for Uniting Care Australia, by The Australia Institute

In the 14 months from July 2010 to September 2011, there was a steep rise in the number of households who believed they would be adversely impacted by significant electricity bill increases, indeed, the changes from March to September 2011, at all income levels were considerable for such a short time period

Observation 10

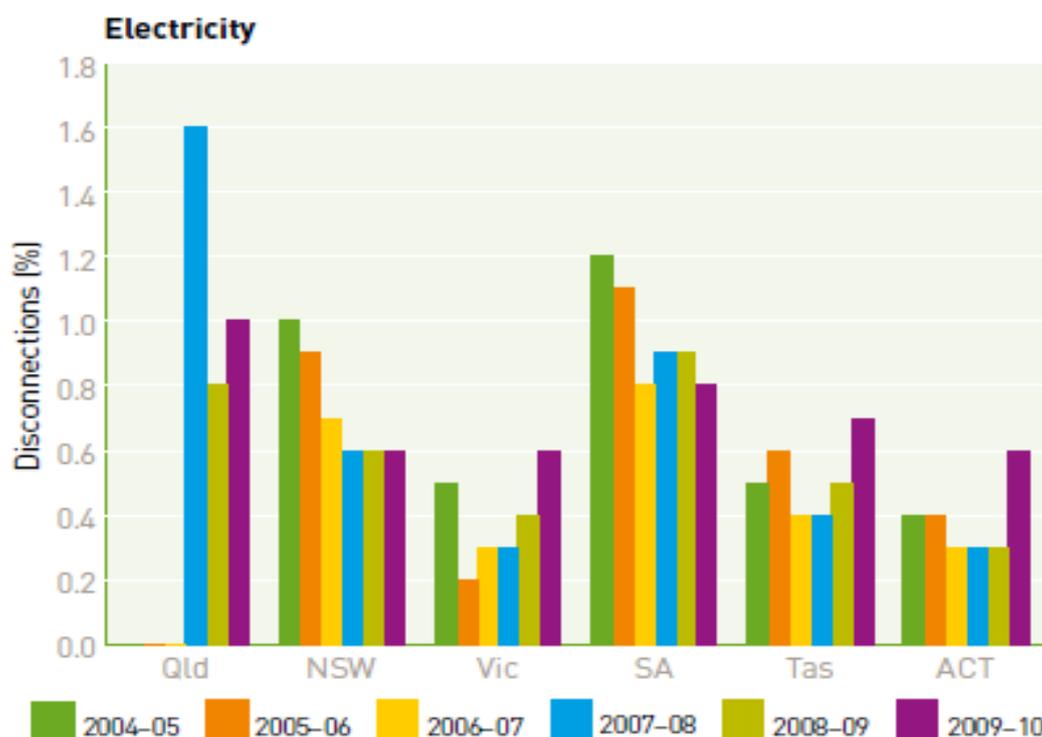
Sharp increase in electricity price rises will have dramatic impact on household budgets, across all income levels

Observation 11

Sharp increase in electricity price rises will impact on health and well being of citizens as well as reduce economic opportunity

Disconnections

A dramatic indicator of energy stress for households is levels of disconnection from supply, due to inability to pay. Recent data on this measure is given below



Graph 20 Source: State of the Energy Market report 2011, AER figure 4.6

This data indicates that rates of disconnections are rising in all jurisdictions except NSW and South Australia, which already have comparably high disconnection rates. It is highly likely that the main reason for increased rates of disconnection is disconnection due to inability to pay, leaving growing numbers of citizens without the essential service of electricity – an unacceptable situation.

Observation 12

Rates of disconnection to inability to pay are unacceptably high, or rising in all Australian states and territories – which is unacceptable

Energy Price Impacts on Community Services

As a network of over 400 organisations across over 1300 sites, right across Australia, we are also acutely aware of the cost pressures that rising energy prices place on community service organisations. While growing numbers of Uniting Care agencies are being proactive in applying energy efficiency measures to their sites, the reality is that for aged care and services supporting people with disabilities, there is no way that resident / participant well being would be compromised by reducing air conditioning use. However, every increase in energy prices, puts pressure on service providers. In aged care, for example, the services most likely to be parred back by rising utility costs are services like art therapy, activities coordinators and the like: the very services that improve quality of life for residents, beyond physical well being

What to Do?

We recognise that there are many components to affordability of electricity, with a range of processes involved, including, at the moment:

- Development of an Energy White Paper
- Merits review assessment
- Productivity Commission review of networks
- NECF implementation
- Carbon pricing
- Energy Efficiency program implementation
- Other Rule change proposals

This rule change is being considered in a time of substantial thinking and reassessment of the impact of the NEM on consumers, it is a very important element, however, of the current actions.

The outcomes of this rule change, we suggest, will have a greater impact on consumers, for better or worse, than many of the other processes underway. The importance of this rule change for consumers must not be underestimated.

Candice & John

John and Candice have recently purchased a house in Adelaide's Northern suburbs. Having no real knowledge of energy efficient design, the ongoing and increasing energy costs were not taken into consideration at the time. Once they had moved into the house they discovered that it was extremely hot as there were a number of windows in the living areas exposed to the sun during the afternoon.

The couple purchased and installed a reverse cycle split system believing they were getting something that was efficient to run based on the information the salesperson had given them about the "Energy Star Ratings" only to find that their electricity bill had almost double over the previous billing period. At the same time Candice was due to give birth to their first child and had to give up work earlier than expected due to health issues.

With only one wage coming in and having accumulated a large energy bill the couple are in financial distress.

SECTION 3

INTRODUCTION

This document is CME's advice to the Roundtable on a response to the AEMC on its Directions Paper. The advice has been drafted as text for a submission so that Roundtable members can use the text in their submissions.

Uniting Care Australia, as host of the project that has engaged CME on behalf of the Roundtable, has decided to reproduce the full text of the CME advice, with some minor editing, in this submission, to ensure that this material is on the public record and considered as part of the delicate considerations of this rule change, and also because Uniting care Australia supports the arguments presented.

This section is set out as follows:

Part 2 provides evidence of the seriousness of the price and productivity problems, at the heart of which is the remarkable increases in prices charged by government-owned network service providers (NSPs);

Part 3 provides some general comments about the approach that the AEMC appears to be taking to these rule change proposals;

Parts 4 to 7 sets out our response to each of the chapters of the AEMC's Directions paper.

Evidence of a problem

The AEMC's Directions Paper suggests that there is limited evidence of a problem, and broadly seems to conclude in many areas that the case for changes to the Rules has not been made.

Uniting Care Australia disagrees with the AEMC on many issues as set out in detail in this section of this submission and we are concerned about the AEMC's apparent lack of concern over the poor outcomes that many of the NEM network service providers have delivered, and the adverse impacts on consumers, as discussed in Section 2

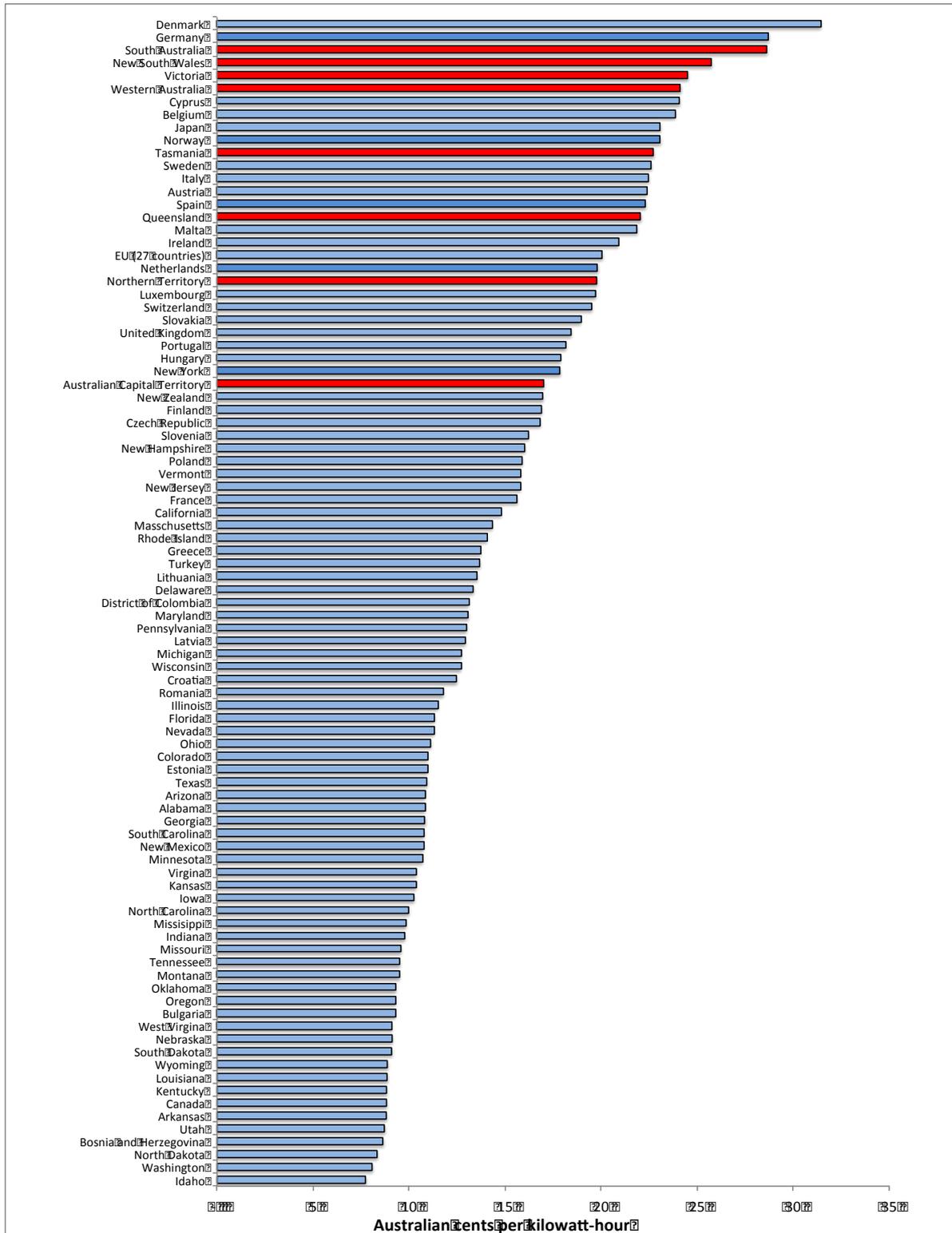
This section provides a brief survey of electricity sector outcomes in the NEM to provide some evidence that there is a problem, on the supply side, as well as the demand side as experienced by consumers. It begins with high level international price comparisons and progressively drills into greater detail in various areas.

This survey presents evidence based on data and analysis provided by CME, the Australian Bureau of Statistics, the Centre for Strategic Economic Studies, the AEMC, the Productivity Commission, Bruce Mountain, and the Australian Energy Market Operator (AEMO). This information provides evidence for the very high level of business and community dissatisfaction with electricity outcomes in the National Electricity Market, and hence the

need for some of the serious and urgent reforms than the AEMC is able to pursue through this very important Rule Change.

Error! Reference source not found. ranks electricity prices in Australia in 2011 compared to those in other developed economies. It is based on the report by CME for the EUAA “Electricity Prices in Australia: An International Comparison”. **Error! Reference source not found.** shows that in 2011, at average 2011 exchange rates, electricity prices in Australia’s main states are amongst the highest in the developed world.

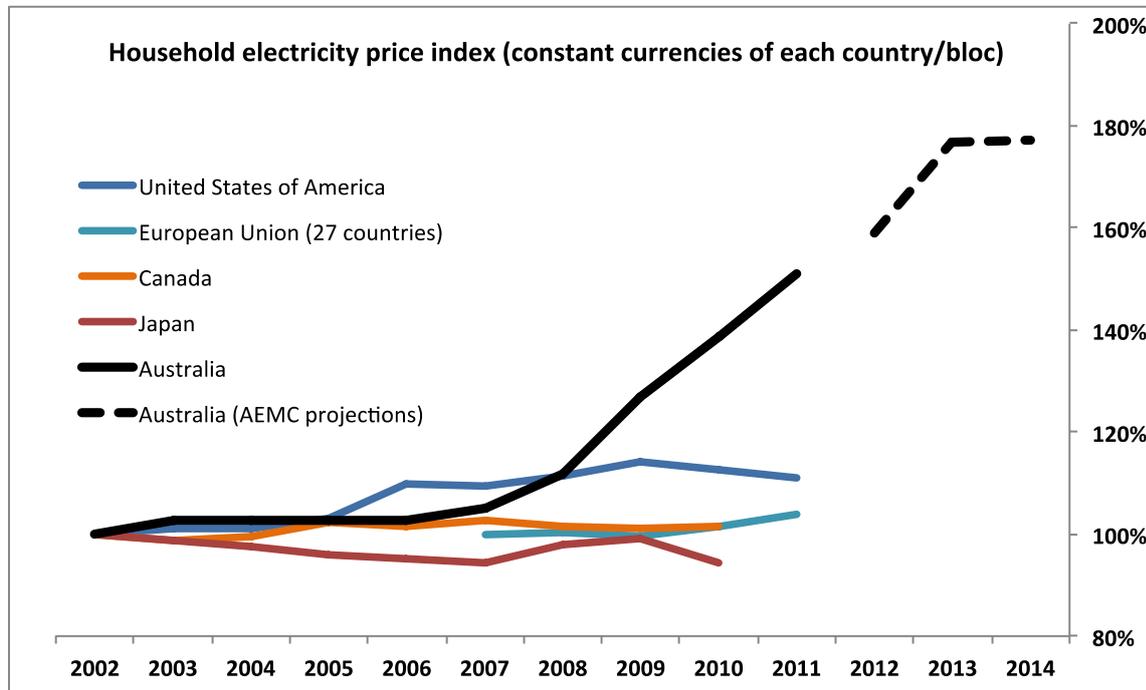
Graph 20. 2011 household electricity prices by country, state and province



Source: Electricity prices in Australia: An International Comparison, CME, March 2012

Australia's declining international competitiveness in electricity particularly since 2007 is attributable mainly to rising prices in Australia, relative to those in other countries as shown in graph 21.

Graph 21. Household electricity price index



Source: *Electricity prices in Australia: An International Comparison, CME, March 2012*

The appreciation of the Australian dollar, particularly relative to the US Dollar and Euro has also increased the gap between Australian prices and those in the EU and U.S. However the Australian Dollar has declined relative to the Japanese Yen and so this has narrowed the gap between Australian and Japanese electricity prices.

The AEMC has projected that household electricity prices will rise by 37% between 2011/12 and 2013/14. If this happens (and we have reason to believe that the actual price increase may be even higher than this) then the electricity prices in most Australian states is likely to be higher than in all other developed economies, by a significant margin. This would be a remarkable outcome considering the many advantages Australia enjoys, relative to so many other developed economies, in its access to energy resources.

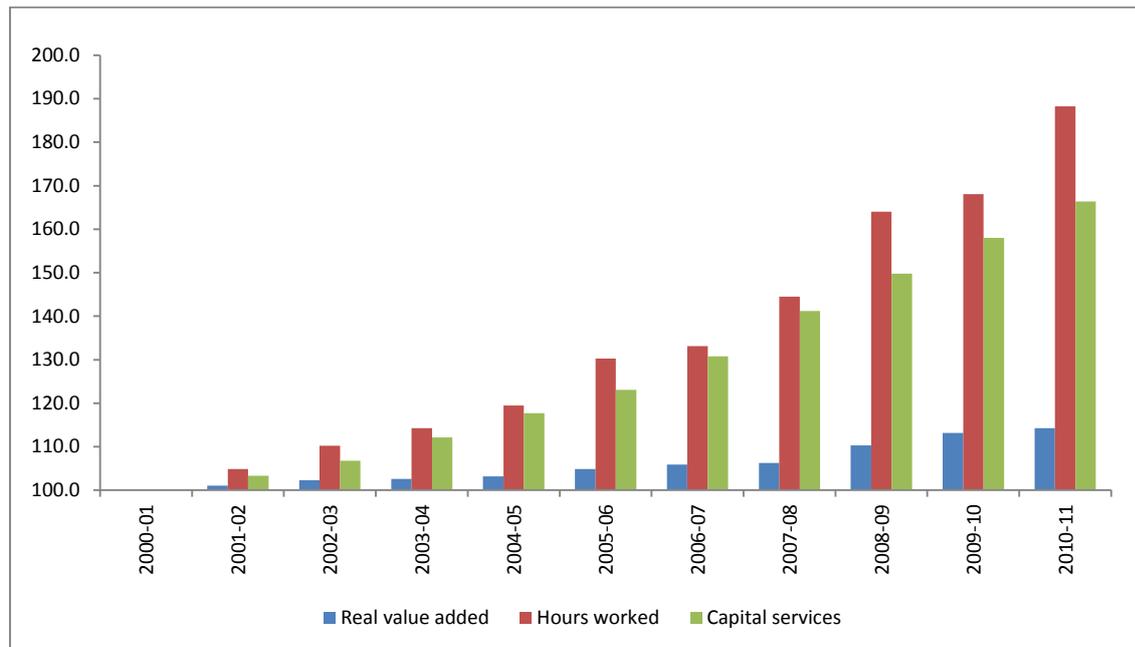
Even without further price increases in the pipeline, the rise in real electricity prices since 2006 (and in real utility prices more generally) is without historical precedent, being about double the increase that occurred in the last episode of rising prices, that in the early 1980s following the rapid growth in electricity capacity to fund the expansion of the aluminium industry.

The AEMC's own analysis attributes the greatest part of the historic and expected price rises to network charges. Of this, government-owned networks have had far higher allowed price increases compared to their privately owned peers. (Uniting Care Australia does not

necessarily believe that this is reason enough to privatise all energy entities, but the detrimental impact on consumers is of major concern)

Rapidly rising prices, but much more gradual change in outputs is reflected in declining productivity. Graph 22 shows the real value added, hours worked and capital services for the electricity, gas and water sector in Australia (of which electricity is by far the biggest component).

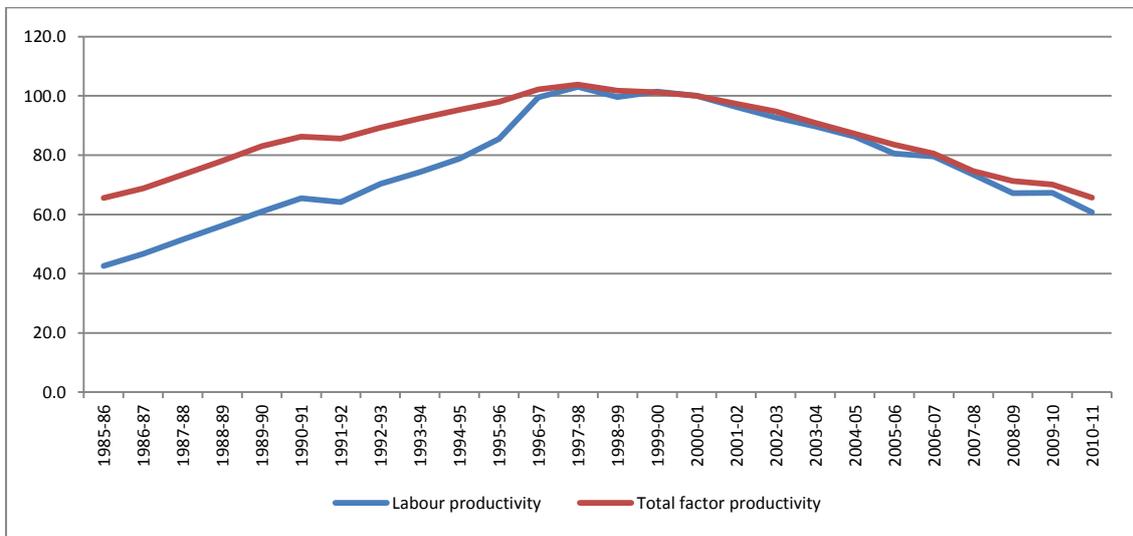
Graph 22. Real value added and capital service use, and hours worked, electricity, gas and water and sewerage industry, Australia, 2000-11 to 2010-11 (indexes 2000-01=100)



**Source: Rate of Return Regulation and Electricity Prices in Australia: Some Notes
Centre for Strategic Economic Studies, March 2012**

Graph 22 shows that over the decade from 2000 to 2010, the real value added rose about 10% while capital services rose about 70% and hours worked about 90%. Clearly small gains in value have been achieved from sizeable increases in capital and labour inputs. This translates into declining productivity as shown Graph 23. This shows that the total factor productivity of the electricity gas and water sector has collapsed over the decade from 2001 to 2010, erasing all of the productivity gains that were made during the previous 15 years.

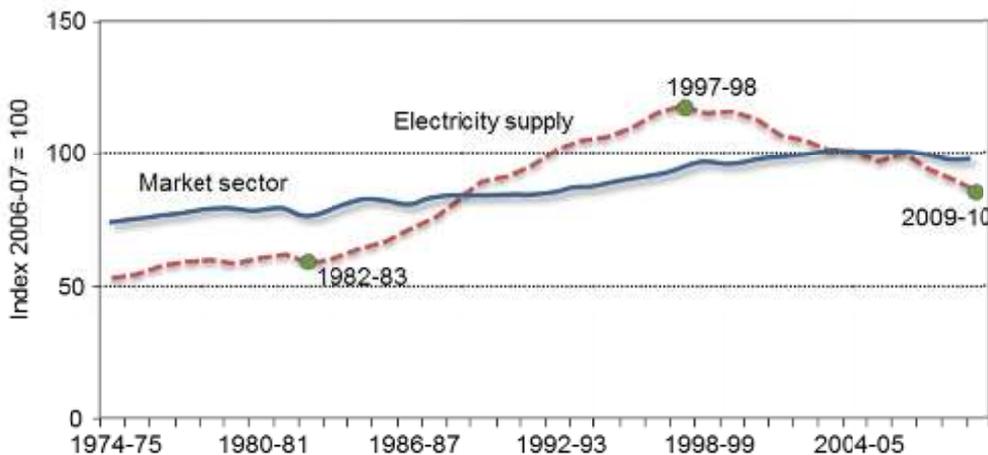
Graph 23. Labour productivity and total factor productivity, EGW, Australia, 1985-86 to 2010-11 (indexes 2000-01 = 100)



Source: Rate of Return Regulation and Electricity Prices in Australia: Some Notes, Centre for Strategic Economic Studies, March 2012

The Productivity Commission in their estimate of multi-factor productivity provides another estimate of the extraordinary decline in productivity of the electricity sector. This is shown in **Error! Reference source not found.** This shows a decline in the multi-factor productivity of the electricity sector of around 30% relative to the market sector, in the decade to 2010.

Graph 24. Measured electricity sector productivity

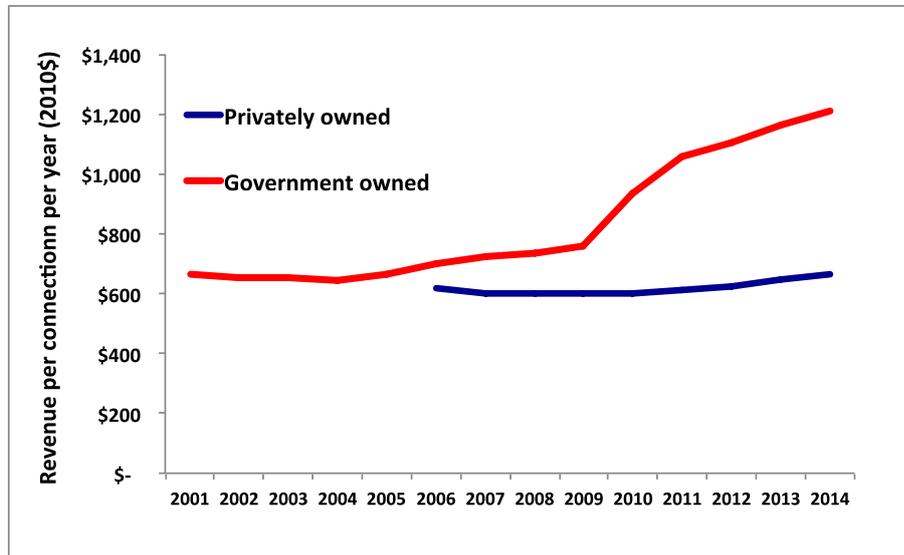


5 %4#1, -7&/ &70% -#B#.! =# 1-' =4F*#*!-1J' =1, , 7%8-176/ &70% -#B#.!\$&7F-*!16' &-1J#B\$!1, , 7%8-176, * 18\$' =! #B!-#97%&180!, 1/ #1+&#/%=E) *'!; 1&J' -!=' , -7&#B, #0' =!1+�%-&# =4F#*!-'! ' U' / -#78!76!16 F!#B0%-&# =! :/ %0-#!110; #B#-&#-#78!180!0' 6 8, ' QF*' &!& #19+!; ' 1=& =!76/ &70% -#B#.!1& !0#B# %!-7!, 1+ %&#-' E ! "# \$%&' () , ? // !180!C%& =!23(2E

Source: *Electricity Network Regulation, Productivity Commission Issues Paper, February 2012.*

The expansion of allowed revenue relative to number of connections is shown in Graph 25. It is clear from this that the problem of rapidly rising revenues per connection is particularly acute for government-owned NSPs. It is this expansion in revenue that explains so much of the observed decline the productivity of the electricity sector.

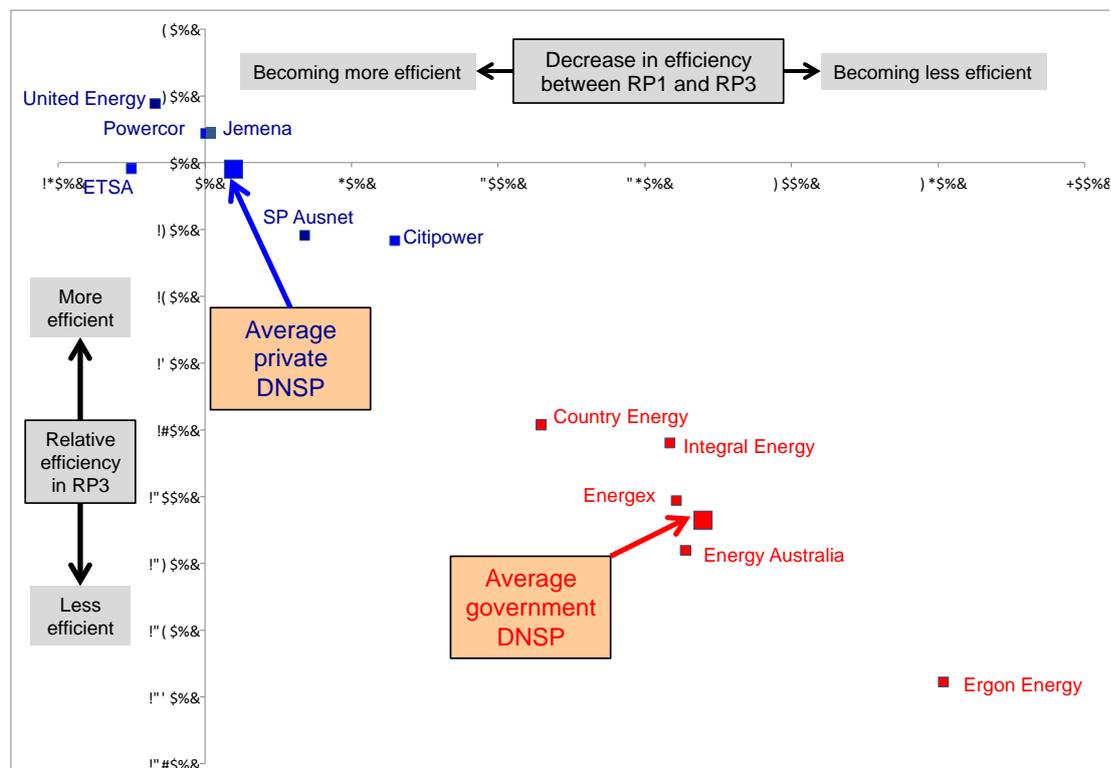
Graph 25. Revenue per connection for government and private distributors



Source: “Australia’s rising electricity prices and declining productivity: the contribution of its electricity distributors”, a report to the Energy Users Association of Australia by Bruce Mountain, May 2011.

The clear gap in the efficiency of the privately-owned and government-owned distributors is shown in graph 26 which compares the relative efficiency of distributors in the regulatory period (RP) currently underway, compared to the change in their efficiency between the first and third regulatory periods. The benchmarking methodology underlying this result is set out in Mountain (2011).

Graph 26. Benchmarking relative efficiency and changes across regulatory periods.

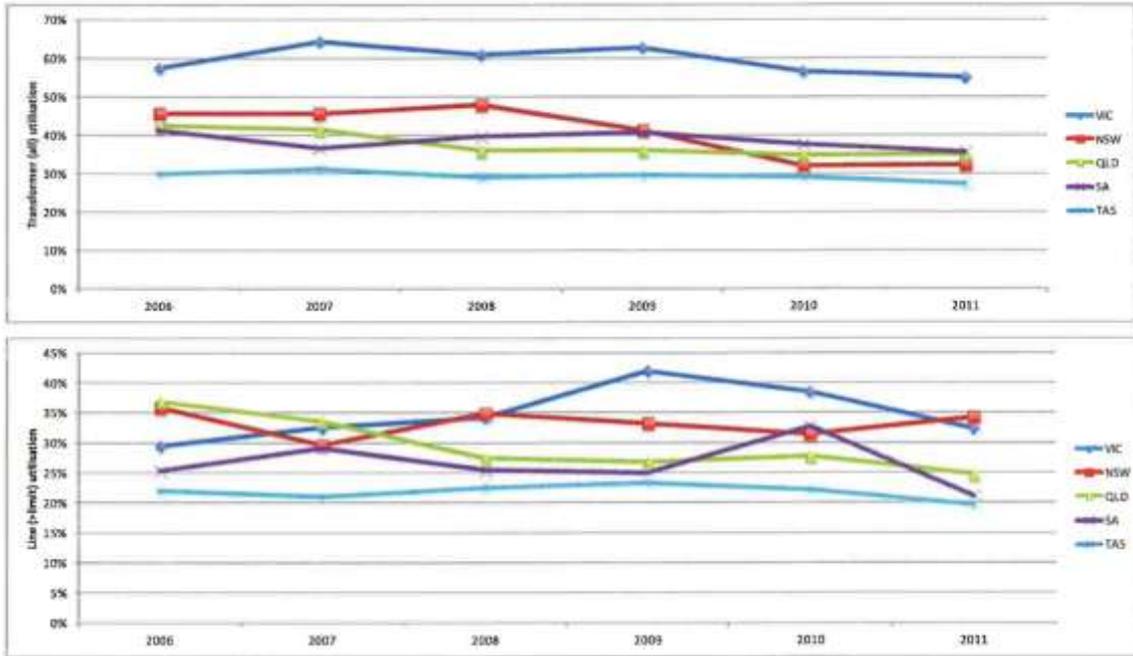


Source: “Australia’s rising electricity prices and declining productivity: the contribution of its electricity distributors”, a report to the EUAA by Bruce Mountain, May 2011.

The AEMC has in the past suggested that the rise in the price of network services is explained by rising peak demand, ageing assets and catch-up investment. As the AEMC is aware, Mountain (2011) suggested that these exogenous factors may explain part of the increase but that government-owned NSPs had spent very much more to meet increases in demand or to connect new customers than privately owned NSPs. Similarly with respect to expenditure on ageing assets, Mountain (2011) suggested that the averaging remaining life of assets owned by private distributors was shorter than for government NSPs and yet government NSPs spent very much more to replace what they claimed to be ageing assets.

With regard to transmission network service providers, AEMO presents some comparative assessment that agrees with the government/private differentiation in distribution networks in Mountain (2011). Graph 27 shows AEMO’s calculation of the utilisation of transformers and lines on the main transmission system. The privately owned Victorian transmission networks show significantly better utilisation than the government-owned networks elsewhere.

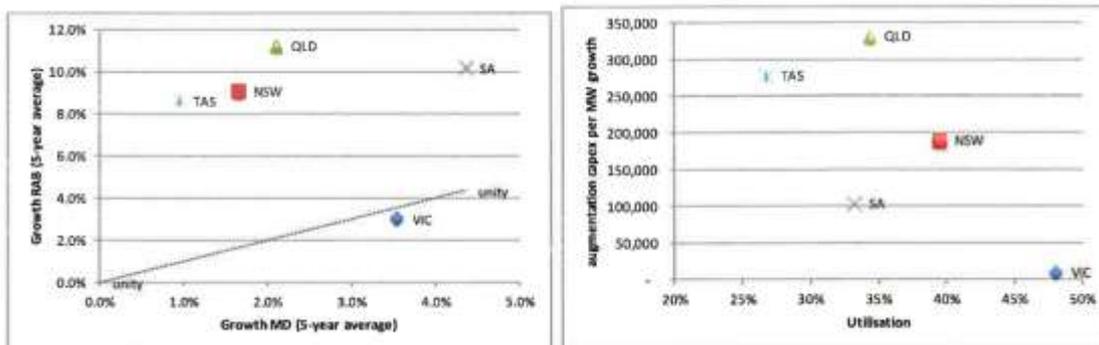
Graph 27. Transformer and transmission line utilisation rates



Source: Submission to transmission framework review first interim report, Australian Energy Market Operator, February 2012.

Graph 28 shows the average annual growth in the RAB from 2006 to 2011 compared to the average annual growth in demand and, in the second chart, the augmentation capex compared to the utilisation of the network. These charts confirm that government-owned transmission network service providers are spending much more to meet (lower) demand growth than privately owned ones, and that relatively under-utilised government-owned transmission networks are incurring far higher augmentation capex than privately owned ones. This accords with the observations in Mountain (2011) and the data presented in this submission in relation to distribution network service providers.

Graph 28. Comparison of expenditure metric



Source: Submission to transmission framework review first interim report, AEMO, February 2012.

Finally, in addition to these data and reports, the AEMC will be aware of the comments of several eminent economists and officials as set out in EURCC's Issues Paper submission, including Professors Parry and Garnaut, Mr Duffy and Mr Sims, all of whom support our contention that there is a serious efficiency problem to be resolved.

Summary

We are concerned that the AEMC's Directions Paper seems unconvinced about the seriousness and urgency of the issues raised in the EURCC's and AER's rule change proposals. This sub-section, as well as the previous section, have provided evidence of the extraordinary price rises and productivity declines in network service provision in the NEM. UnitingCare Australia consequently urges the AEMC to apply the rule change proposals that, we are persuaded, will go some way to addressing this situation which is so adverse to consumer best interests.

GENERAL COMMENT ON THE AEMC'S APPROACH

This sub-section provides a few general comments on the AEMC's approach. These comments apply to much of the Direction Paper although in parts of our response to specific areas of the AEMC's Directions Paper we draw attention to them again.

Evidence

Considering the significance of these rule change proposals, we are surprised that the AEMC has taken a 'hands off' approach to evidence, rather than augmenting stakeholder input with its own research and examination of the data, to discover whether there is a problem, and if so its magnitude and type. The only quantitative research that the AEMC appears to be undertaking itself following the Directions Paper is to understand the reason for overspending by some NSPs against their regulatory allowances. In the Issues Paper, the AEMC exhorts the AER and the network service providers to provide it with evidence, and to critique existing analysis. While stakeholders should be encouraged to present as much evidence as they can, we strongly urge the AEMC to commission, seek out and evaluate evidence itself and not just rely on information and analysis provided to it by stakeholders.

Regulatory design, implementation and industry governance

In this review the AEMC appears to have placed considerable emphasis on distinguishing three possible reasons for the observed outcomes: regulatory design, regulatory conduct and governance. When the AEMC has drawn attention to this distinction, such as by the Chairman at the Issues Paper forum in Brisbane in November 2011, the point has been made that there should be realistic expectations of what might be delivered through changes to the Rules. It also seems that by categorising the issues in this way the AEMC appears to be drawing attention to the question of whether regulatory failures might be better explained through failures in regulatory implementation and industry governance, rather than the design of the regulations themselves.

We agree with the AEMC that there is merit in categorising the factors that determine regulatory success or failure and analysing problems under these three headings. This can deliver a more precise statement of the problem, and hence facilitate clearer and more precisely targeted solutions.

However, we suggest that the lines between design/implementation/governance cannot always be clearly drawn. For example, in its assessment of the Energy Users Rule Change Committee's (EURCC's) proposals we suggest that the AEMC has failed to apply the NEO.

This is an implementation failure, not a design failure, and this implementation failure is in the AEMC's jurisdiction, not the AERs.

Furthermore, these three dimensions are inter-linked in other ways: better design may promote better implementation; better governance may promote better design and better implementation. In other words, we suggest that in many ways they are not neatly separable.

Finally and most importantly, we suggest that regulatory design has special significance since failures in design not only affect outcomes, but they also affect who bears the incidence of those outcomes. As we explain in more detail in response to specific parts of the Directions Paper, the steep rise in electricity prices and decline in industry productivity has been at the expense of the industry's consumers, particularly small use consumers, not its shareholders. It is regulatory design, not industry governance or regulatory implementation that has determined this.

We encourage the AEMC to consider a more holistic assessment of the problem. Consideration of regulatory design should be situated in the context of its implementation and the industry governance arrangements including the impact of ownership arrangements on industry governance. Specifically this might mean:

Ensuring that design takes account of weaknesses in industry governance. This applies particularly to government-owned NSPs where the evidence suggests that their ability to control expenditure is very much weaker than their privately owned peers. Regulatory design can deal with this by ensuring that it caters for differences in industry governance, including;

- Having regard to what the AER considers to be the constraints in the Rules that impede it from making decisions that it considers to be consistent with the NEO. While others might argue that the AER has whatever power it needs to do its job, we suggest the AEMC should have special regard to the AER's claim that it does not.

Comparative analysis

We strongly believe that comparative analysis is essential in assessing the evidence of a problem, and then defining the problem and designing targeted solutions. We are concerned that the AEMC appears to have had low regard, so far for comparative analysis. The only area where we understand the AEMC intends to develop a comparative analysis is to check whether the Chapter 6A "policy intent" is consistent with the actual practice of other regulators. It is not yet clear to us what this means. If it reduces to a parsing of the NEO to confirm whether it accords with accepted best practice in the economic regulation of network monopolies, then we can predict with confidence that the policy intent will be found to be appropriate. But this, surely, is not informative. Comparative assessments

should be made of actual outcomes not of intentions and “intent” and objectives. As such the comparative assessment that we encourage the AEMC to undertake is of the actual outcomes that has been delivered under Chapter 6A (and Chapter 6) compared to the outcomes that have been delivered in other countries.

CAPEX AND OPEX ALLOWANCES

This section responds to the regulatory design issues that are described and reviewed in Chapter 3 of the Directions Paper.

We think that the issues that this chapter deals with are amongst the most important of all the issues that are being reviewed by the AEMC pursuant to the AER’s rule change application. This section describes the problem as suggested by the AER, NSPs, consumers and governments, the AEMC’s advisors and finally the AEMC, as we understand each perspective. We think it is useful to be able to ‘check out’ the accuracy of our perspectives to help find as much common understanding as possible with this complex rule change. We then present a critique of the AEMC’s initial conclusions and its proposed approach, as we understand them. Finally we set out our perspective of the problem and the solutions that we suggest that the AEMC might consider.

Stakeholders’ statement of the problem

AER

The AER proposes that it should not have to justify its decisions on NSP opex and capex allowances with reference to the proposals put to it by NSPs. It says that it has been forced into a line-by-line assessment of expenditure proposals by the NSPs, and that it has been constrained in its ability to apply benchmarks in its determination of expenditure allowances. It suggests that both of these have worked to the advantage of NSPs and the expense of consumers.

NSPs

The NSPs say that there is nothing constraining the AER from setting efficient expenditure allowances, and that the AER has been able to benchmark as it wished to. The NSPs suggest that the requirement that the AER takes account of the specific circumstances of the distributor are valid requirements.

Retailer, jurisdictional regulator, consumer and government views

IPART, consumer representative organisations, the South Australian and Victorian Governments are generally supportive of the AER's proposal. In general their interpretation of the AER's proposal is that the AER is seeking to given more power and flexibility to determine expenditure allowances as it wishes to.

Advisors

In a general comment, Professors Littlechild and Yarrow seem to suggest that the AER has not made a case for changes to the regulatory regime. Nevertheless both professors incline to the view that the AER should have more discretion than it currently has.

AEMC's directions

The AEMC begins its assessment by pointing to regulatory design as just one factor (governance of NSPs and regulatory implementation by the AER being the other two) that affects outcomes. By implication, the AEMC seems to be suggesting that undue focus on failures in regulatory design is not warranted, and also that it would be unrealistic to expect that remedying flaws in regulatory design will necessarily result in significantly better outcomes.

The AEMC then suggests that there is disproportionate focus on high prices, and that if prices were lower than needed to meet "relevant objectives," this would not be in consumers' long-term interest.

The AEMC suggests that it is not convinced that the AER has too little authority or flexibility. It also concludes that the AER has been able to benchmark expenditure as it needs to and so it sees no need to change the rules in respect of benchmarking.

The AEMC notes the evidence provided by Mountain and Littlechild (2010) and Mountain (2011) but says that this evidence does not "conclusively" rule out asset ageing, rising peak demand and quality changes as factors requiring greater opex and capex.

The AEMC considers that the policy intent underlying Chapter 6 is consistent with the actual practice of Ofgem in Britain.

In summary, the AEMC's initial conclusions seem to be that:

The AER's is able to set efficient opex and capex allowances under the current rules;

If NSP's opex and capex allowances are too high it, it is not because the AER lacks flexibility or authority.

Comment on the AEMC's directions

We are concerned about many aspects of the AEMC's underlying thinking, as we understand it, and the AEMC's analysis in this area.

Firstly, we don't dispute that regulatory design is but one significant factor affecting outcomes (the others being the conduct of regulation and industry governance). We also do not dispute that improving regulatory design is no guarantee of efficient outcomes. The AEMC seems to point this out as if to lower the importance of good regulatory design, and by extension, lower expectations of the efficiency improvements that might be expected from better design. This reflects comments that the AEMC has made on other occasions, that it is not the job of the regulator to correct for failures in industry governance. But this seems to miss the point that it is the design of regulations that determine whether it is consumers or shareholders who bear the consequences of weaknesses in regulatory conduct and governance. While good regulatory design is necessary but not sufficient to ensure good regulatory outcomes, bad regulatory design is sufficient to ensure that consumers bear, unfairly, the consequences of bad regulatory outcomes.

Secondly, the AEMC has overlooked the fact that the higher prices that are currently the subject of so much community, business and political focus, are at consumers' expense, not the industry's shareholders' expense. This is why we have gone into some detail in section 2 to present the small consumer experience of runaway electricity prices. While consumers are suffering the pain of higher prices, the owners of Australia's network service providers are enjoying the fruit of these higher prices in the form of corporate valuations at a substantial premium to their current cost regulated asset bases (in the case of privately owned NSPs), and governments that are extracting remarkable profits, taxes and fees from the NSPs they own. Evidence of this can be seen in the financial analyst reports that the AEMC itself cites in the Directions Paper and also in the EURCC's proposal, the New South Wales Treasury's response to their proposal and the EURCC's rebuttal of the NSW Treasury's response.

Third, we are concerned at the way that the AEMC has drawn attention to the possible detriments of low prices, as if through this to promote greater acceptance of high prices. Consumers would not dispute that prices need to be at levels needed to attract investment to meet reliable supply. But why does the AEMC feel the need to point this out? Why is the AEMC so concerned about the attention that has been drawn to high electricity prices, that it feels the needs to point to possible detriments associated with lower prices? The directions paper, we suggest, does not adequately reflect the other side of this argument, the consumer detriment of high prices and continued price rises.

Fourth, the AEMC's analysis of the AER's ability to benchmark is also a concern. The AEMC concludes that the AER has been able to develop and use benchmarks in the determination of opex and capex allowances and has been unconstrained in this. We suggest the evidence does not support this. For example, we point to the critique of the AER's benchmarking set out in the EUAA's submission on the AER's Draft Decision for the revenue and price controls for the distributors in Queensland and South Australia, see the AER's website. The EUAA analysis of the benchmarking undertaken by the AER for these decisions was that:

1. There was no evidence of benchmarking, of any form, of capex;
2. The AER defined a role for benchmarking opex that was inconsistent with its obligations under the Rules;
3. The AER failed to define the benchmark efficient opex as it is required to do under the Rules;
4. The AER benchmarked *historic* expenditure (not the proposed expenditure for the regulatory period for which the price/revenues controls were to be established);
5. There is no evidence that the AER took account of the opex benchmarking that it did do, in setting opex allowances.

Similar comments can be made about the AER's benchmarking in the distribution decisions for distributors in Victoria and New South Wales.

In its defence the AEMC might argue that the AER is empowered by the Rules to develop benchmarks, it is just that the AER failed to do this. We agree with this to a point. However, in the AER's defence, we agree that the AER's argument that obligation in the Rules for the AER to take account of the specific circumstances of NSPs, and also its obligation to justify its decision against the NSP's proposal mitigates against the use of benchmarks as described in the Rules.

Finally with respect to the evidence presented in Mountain and Littlechild (2010) and Mountain (2011), the AEMC noted the Energy Users Rule Change Committee "*attempted to rebut the claims that expenditure outcomes are attributable to rising demand, ageing assets and historic underinvestment*". The AEMC said that Mountain and Littlechild (2010) and Mountain (2011) set to "*rule out these factors*", which in the AEMC's assessment they have failed to "*conclusively*" do.

We suggest that the AEMC appears to have mischaracterised their research. The evidence in both Mountain and Littlechild (2010) and Mountain (2011) recognises that rising demand and ageing assets are factors that in some cases have justified higher expenditure. But their point is that other factors (regulatory design, regulatory conduct and ownership) also seem to explain higher expenditure. They have not sought to rule out rising demand, ageing assets or historic underinvestment as factors that may have justified higher expenditure in some cases, but rather have concluded that exogenous factors seem at least as important as

these endogenous factors. It would be helpful for the AEMC to explain in what sense it thinks that this research “*has some merit*” and in what way the AEMC thinks it does not.

Statement of the problem and suggested solutions

Problem

We are concerned that the combination of the AER’s proposals, the resulting Issues Paper submissions and the AEMC’s Directions Paper has not clearly defined the problem and consequently the rationale for a solution, or the nature of the most appropriate solution.

The AER has said that the current rules unreasonably constrain it, but has not described clearly in what sense it is constrained. We also agree that the AER has not established clear evidence that it has been unreasonably constrained or of the efficiency detriments attributable to the purported constraints. The NSPs have argued, not unreasonably, that the AEMC could have done things differently if they chose to. The AEMC has generally sided with the NSPs but said it will look again at the evidence of a problem.

In our view, this debate has been misdirected and so misses the point. The nub of the problem, in our opinion, is not whether the AER is constrained by “reasonableness” requirements or whether it is limited to make the minimum changes needed to meet the objectives of the Rules, as the AER has argued. We agree with NSPs and the AEMC that neither of these two constraints, of themselves, unreasonably constrain the AER, as the AER suggest they do.

Rather, the core of the problem, we suggest, is the requirement in the Rules that the AER has to justify its decisions with reference to the NSP’s proposals. Under the Rules it is for the AER to prove to an NSP that the NSP’s proposal is wrong, rather than for the NSP to prove to the AER that its proposal is right. This arrangement was established by the AEMC during the Review of Chapter 6 of the National Electricity Rules. At the time, the AEMC described this “propose-respond” model as “*purely a procedural mechanism ... (that) is not intended to extend to the regulatory decision making criteria that apply to different elements of the overall regulatory model.*”⁵

However, as set out in Mountain (2011, page 51) the Australian Competition Tribunal (ACT) in an appeal by one of the distributors against an AER decision, provided a clear description of how the propose-respond model establishes the onus of proof. In particular, the ACT describe the operation of the proposed-respond model in the Rules as follows⁶:

⁵ AEMC, 2006. “*Draft Rule Determination, Draft National Electricity Amendment Rule 2006, July 2006*”, page .

⁶ Australian Competition Tribunal, 2009. “ACompT 8”, paragraph 190.

1. Distributors must provide expenditure forecasts in accordance with the National Electricity Objective as described by the three criteria in the Rules;
2. The AER must accept the distributor's forecast if it is satisfied that the total of the forecast reasonably reflects the three criteria;
3. It is not the AER's role to make a decision it considers best ... the AER should be very slow to reject a distributor's proposal if it is backed by detailed, relevant independent expert advice because the AER, on an uninformed basis, takes a different view;
4. The AER must not reject such a proposal merely because it has an expert opinion. The AER, based upon any expert advice, needs to make its own evaluation, an evaluation that is reviewable by the Tribunal.

It should be clear from this, that under the Rules the onus of proof lies with the AER to prove NSPs wrong. This arrangement, in our opinion, is more likely to deliver regulatory assessments of opex and capex allowances that are overly generous to NSPs. The argument to support this opinion rests on a consideration of the information asymmetry between NSPs and the AER, and the implications of this for whether the AER's regulatory judgements are more likely to err in favour NSPs or their customers.

NSPs have an obvious information advantage relative to the regulator, since they own and/or operate the assets the revenues of which the AER regulates. This information asymmetry is well accepted in the academic literature and by regulatory practitioners. If the regulator's task is to assess an NSP's application as the ACT has described their task, then NSPs are in a position to use their proposals to the AER to lead the AER through its assessment in a way that limits the ability of the AER to disagree with it. By setting the regulators' task as one of followership (responding) to the NSP's application, rather than for the NSP to respond to the AER's proposals, the AER will be reacting, rather than pro-actively itself to direct the investigation that it wishes to undertake.

In an environment of very significant expenditure, reasonably long forward expenditure projections (5 year price/revenue controls) and significant technological complexity neither the regulator nor the NSP can know for certain what the efficient level of future expenditure might be. Ex-ante estimates of future efficient expenditure whether made by the NSP and the AER will almost certainly be wrong: if the efficient level of future expenditure was known it would not be necessary to develop incentives to encourage it to be revealed. The regulatory design issue therefore is whether the unknown error will more likely than not be

in favour of the NSP or of its customers. If the “forecast” error is symmetrically distributed (i.e. the AER is as likely to over-estimate efficient expenditure as under-estimate it) then the regulatory design may be considered acceptable. If it is asymmetrically distributed (more likely to be too little or too much) then this would suggest a problem, particularly in the long run interest of consumers.

We suggest that the information asymmetry in favour of NSPs combined with a regulatory arrangement where the NSP proposes and the AER responds to the NSP’s proposal (and is required to prove the NSP wrong) will mean that the error will invariably be asymmetrically distributed in favour of NSPs (i.e. expenditure allowances will be too generous). In other words, putting the onus of proof on the AER to prove the NSP wrong is more likely to result in regulatory allowances that favour NSPs rather than consumers. This is because, in delving into an NSP’s expenditure claim in any area, the AER’s informational disadvantage relative to NSPs will predispose it to deliver judgements that err on the side of the NSP.

This is compounded by the arrangements for merits review, where individual AER decisions are subject to review by the Australian Competition Tribunal. The NSPs have argued that this arrangement delivers accurate and rigorous outcomes since they, not the regulator knows their business best, and also because the threat of merits review will encourage the regulator to undertake a rigorous assessment of their claims. The alternative view, and the one we suggest is right, is that the AER will invariably be less capable than the NSP in proving the NSP wrong, than the NSP is able to propose to the AER that it is right and so the merits review arrangements simply worsen the AER’s position.

In summary considering the onus of proof established in the Rules and taking account of the incentives on NSPs to propose higher expenditure than needed, the information asymmetry in favour of NSPs, and the arrangements for merits review we conclude that regulatory assessments will invariably, and unreasonably, err in favour of NSPs rather than consumers.

Finally, we would also like to draw attention to an additional, procedural but significant problem with the onus of proof. This is that it confers to NSPs the ability to feed the information to the AER, to the NSP’s benefit. This can be seen in the problem of NSPs making submissions on their proposals and making last-minute submissions to the regulator. If the AER is required to justify its decision against the NSP’s proposals, this allows NSPs to strategically use the proposal and information provision process to its advantage and to the detriment of proper and transparent consultation. Indeed, this approach by NSPs effectively locks consumer voice out of the process because they are making submissions on the basis of incomplete information further exacerbating systemic asymmetry.

If the AER is not required to justify its decision against an NSP’s proposals, NSPs will no longer have an incentive (or ability) to game the regulatory process. To the contrary, they will have every incentive to comply with the regulator’s requests as soon as they can. We return to this issue in our submission on regulatory process.

Solution

Uniting Care Australia strongly support the AER's Rule Change proposal that it not be required to justify its determination of opex and capex allowances with reference to the NSP's proposals. The AER should be free to determine the allowances without being required to justify variations from the NSP's proposals. This correctly re-establishes the onus on the NSPs to justify their proposals to the regulator rather than the other way around.

CAPEX INCENTIVES

This section responds to the issues that are described and reviewed in Chapter 4 of the Directions Paper.

Stakeholders' statement of the problem

AER

The AER says that the efficiency incentives in the current regulatory design are too weak. This applies whether or not forecast or actual depreciation is used. The core element of their proposal in this area is only to include 60% of any capex overspend into the regulatory asset base.

In addition, the AER wants:

- discretion to use actual or forecast depreciation in establishing the closing regulated asset base;**
- to include capex re-openers and contingent project arrangements for the regulation of distributors' capex;**
- to exclude related party margins in setting capex and opex allowances both ex-ante and through ex-post reviews;**
- discretion to change existing incentives or introduce new ones.**

NSPs

The NSPs don't think there is a major incentive design problem, although they seem to prefer constant efficiency incentives for each year during a regulatory control period, rather than the existing ones whose power steadily declines over the period.

NSP think that the AER's analysis of the power of incentives is flawed because NSPs don't know what the allowed future rates of return are, and hence analysis based on the difference between future actual and allowed rates of return is invalid.

NSPs seem to agree that the AER should have discretion to decide between actual and forecast depreciation and they seem to agree that there is an issue with related party margins. However they disagree with the AER on all other points and disagree with the solutions that the AER has proposed in all areas.

Retailer, consumer and government views

We side with other consumer representatives agree that capex efficiency incentives are too weak. They generally suggested though that more work needed to be done to assess whether the AER's 60% roll-in proposal was the best solution. On the subsidiary incentive design issues:

Some consumer representatives suggested that forecast or actual depreciation should be locked in rather than discretionary, others took the opposite view;

Retailers and consumers were generally not supportive of proposals to allow capex-reopeners and contingent projects in distribution regulation;

The Victorian Government's Department of Primary Industries pointed to ossified incentive designs but did not say whether they supported the AER's proposal to design incentives outside the Rules.

AEMC's directions

The AEMC doesn't seem to be convinced that there is a serious capex incentive problem. It suggested that incentive design should not have regard to any difference between the allowed rate of the return and NSPs' actual cost of capital, and that having ignored this possible difference, the existing incentives don't encourage NSPs to overspend. The AEMC does however seem to be concerned about the declining power of the incentive over the regulatory period and suggests that this create a risk of "sub-optimal" timing of capex from an engineering point of view. The AEMC also seems concerned about the lack of supervision of overspends, although it seems much less concerned that there is a problem if NSPs spend up to their allowance.

The AEMC disagrees with the AER's 60% proposal because it says that it does not provide continuous incentives over the regulatory period, would be common to all NSPs and would exclude overspends from the RAB even if such overspend was purported to be efficient. A more general concern is that the AEMC thinks that prescribing an incentive scheme in the Rules would create a barrier to the implementation of other schemes "through negotiation".

The AEMC seems to favour an approach to incentive design in which broad criteria are stated in the Rules and the AER is then left to design the incentive, such as for example the Efficiency Benefit Sharing Scheme that applies to opex.

On other incentive design issues, the AEMC:

- seems open to further consideration of the merits of ex-post optimisation;

- has no firm view on actual or forecast depreciation;
- thinks that re-opener and contingent projects should be extended to distribution;
- is undecided on the treatment of related party margins;
- doesn't think the AER should be empowered to develop incentive schemes outside of those already provided for in the Rules, other than as minor "pilot" schemes.

Our comments on the AEMC's directions

We disagree with the AEMC's analysis of the problem. We suggest their approach:

1. is inconsistent with accepted regulatory theory;
2. ignores the evidence of significant capex overspend; and
3. fails to properly account for differences in the cost of capital between privately-owned and government-owned NSPs.

On the first of these three criticisms, the AEMC suggests that the design of capex efficiency incentives should ignore any difference in the actual cost of capital of an NSP and their allowed rate of return. This view is not supported by Uniting Care Australia. We believe that it is well established that the power of capex incentives (i.e the shareholders' proportion of the benefit attributable to expenditure reductions) depends on several factors including the year in which the saving is made, the asset life and the difference between the allowed rate of return and NSPs actual cost of capital.

This is clearly set out in the AER's proposal to the AEMC. It was also covered in detail in the AER's submission to the AEMC in 2005 during the Chapter 6 review, during which the AER commissioned monte-carlo modelling of different incentive designs to determine their power as a function of different asset lives, year in the regulatory control period and difference between actual and allowed rates of return.

We re-iterate our concerns about this matter. If an NSP has a lower cost of capital than the regulator thinks it has (and has allowed it in setting its prices) then the NSP will trade-off the 'disbenefit' of losing the return (and possibly also depreciation) on any overspend during a regulatory control period, against the benefit of a higher return than it requires for the rest of the life of the asset. In this way, NSPs may prefer to spend more than they are allowed to during the regulatory control period because this maximises their profitability.

It is obvious from this that the NSPs' actual cost of capital is a critically important variable in making judgements about the power (and hence effectiveness) of regulatory incentives applied to its capital expenditure. We do not think it is accepted regulatory practice to do as the AEMC has done, and ignore this in making a judgement on the effectiveness of the existing capex efficiency incentives.

Even the Energy Networks Association accepts that the difference between the allowed rate of return and actual cost of capital is a significant variable in assessing the power of the capex incentives. However the ENA then tries to undermine the AER's proposal saying that since they do not know the allowed rate of return in future regulatory decisions, NSPs will simply assume that it will equal their actual cost of capital. This is obviously flawed: if the actual cost of capital is different to the allowed rate of return during the regulatory control period, on what basis would they automatically assume that in subsequent regulatory control periods it will be equal to their actual cost of capital (whatever this may be)? It is far more likely that NSPs will develop analyses and projections of what the future may hold and reflect this in their evaluation of incentives. Indeed the wealth of speculation on this by utility equity analysts is testament to exactly this.

On our second criticism (ignoring the evidence of significant capex overspend), Mountain (2011) and the AER's proposal sets out the evidence of a systemic problem of capex overspend against regulatory allowances by government-owned distribution network service providers in Tasmania, Queensland and New South Wales. These overspends were achieved under regulatory controls established by jurisdictional regulators. The incentives applying to capex spending in these controls were the same, or very similar, to the controls established in the Rules.

Further evidence of overspend by government-owned NSPs can be found in the outcomes delivered by government-owned transmission network service providers regulated by the ACCC and then the AER since 1999, which is also covered in the AER's proposal.

To the extent that the AEMC has concluded that the capex incentives are acceptable, the AEMC appears to have ignored the evidence of significant and persistent overspend by government-owned NSPs. The AEMC appears to be either unconvinced of this evidence, or it considers that the regulatory design is fine, but the reasons for the overspend lie elsewhere (such as regulatory conduct – i.e. the AER set the wrong expenditure allowances in the first place; or governance i.e. government-owned NSPs have poor expenditure control).

We are somewhat sceptical that it will ever be possible to pin-point the cause of the failures precisely – even with sophisticated analysis, the issues are arguable. Perhaps to varying degrees they are a combination of each of the three factors (design, conduct and governance). However, from our perspective this does not diminish the central importance of regulatory design (of which incentive design is a key element), since it plays such a significant role in determining whether consumers or shareholders bear the consequence of design, conduct or governance failures.

With respect to our third criticism (failing to account for the differences in the cost of capital between government and privately owned NSPs) the AEMC has assumed that the cost of

capital for government and privately owned NSPs is the same. Or perhaps to be more precise, by virtue of ignoring the difference between the actual cost of capital and the allowed rates of return in its assessment of the effectiveness of the incentive, the AEMC suggests that none of the blame for the overspend can be attached to the fact that government-owned NSPs have a lower cost of capital than privately owned NSPs.

We suggest that it is extremely likely, if not certain, that government owned NSPs have a lower cost of capital than privately owned NSPs. There are several reasons for this including:

- That governments collect the tax on the profits of their NSPs and so their after- tax returns are higher (by the corporate tax rates) than the returns achieved by privately owned NSPs (even the Independent Pricing and Administrative Tribunal of New South Wales accepted this in their submission on the AEMC’s issues paper).
- Governments collect fees on the debt they provide to their NSPs. State governments that own NSPs are currently able to borrow money at around 4.5% and based on their own admissions lend this money to their NSPs at more than 7%). Privately owned NSPs are not able to borrow money at the same price at state governments, under the Rules both privately and government-owned NSPs are allowed the same return on debt and hence the same cost of capital.

These issues are discussed in greater depth in the EURCC’s proposal and in their response to the AEMC’s Directions Paper and we refer the AEMC to that submission.

Finally we disagree with the AEMC’s conclusion that capex efficiency incentives that have a constant power for each year of the regulatory control period are necessarily preferable to incentives whose power declines over the regulatory period. The use of constant-power incentives for opex (through the Efficiency Benefit Sharing Scheme) is intended to deal with a regulatory gaming problem: since the regulator places a high reliance on the opex in the last year of the regulatory control period to set the opex for the next years of the coming regulatory period, NSPs have an incentive to “game” the incentive by deferring expenditure to the last year of the control. If they have a constant-powered efficiency incentive they have less reason to do this. This is not an issue that affects capex (where the actual expenditure in any year of the regulatory period has little value as a predictor of the efficient level of capex in the coming regulatory period).

Furthermore the AEMC’s analysis of this issue (constant powered capex incentives) fails to give appropriate credence to information asymmetry and economic incentives. The AEMC says that declining incentive creates the *“risk of sub-optimal timing of capex since capex that may be required from an engineering point of view may be delayed. These incentives may also create a risk of the sub-optimal use of inputs”*. This ignores the opportunity an NSP has to substitute expenditure, to seek out innovative ways to meet its reliability objectives, to negotiate with its customers about deferring augmentations, to encourage embedded generation or demand-side reductions and so on? How can we be sure, as the AEMC

suggests, that varying incentive power will risk “sub-optimal timing of capex” or “sub-optimal use of inputs”. Furthermore, since NSPs in Australia have been exposed to declining powered capex incentives since 1999 (and earlier in some cases), the AEMC might be expected to point to this evidence to substantiate its concerns.

It seems to us that the key issue in considering declining incentive power over the regulatory period (for capex), but constant powered incentives (for opex) is that this may encourage NSPs to inefficiently substitute between the two, in order to maximise its rewards, but for no useful purpose to consumers. This is the relevant issue and the one that the AEMC should examine. WE URGE the AEMC TO examine this issue in this review.

Our comments on the AEMC’s analysis of the other, subsidiary, incentive design issues is set out in the rest of this sub-section:

Ex-post optimisation

The AEMC entertains the prospect of some form of ex-post optimisation and has suggested that an ex-post review might exclude projects that had been the subject of some sort of regulatory investment test. We are not convinced about this. Simply because a project has passed an ex-ante regulatory test is no guarantee that the resulting costs were efficiently incurred. For example, in the only regulatory example of ex-post optimisation by the ACCC (or AER), in the 2004 revenue cap decision for TransGrid, the ACCC decided to exclude around \$30m of the expenditure that TransGrid incurred on that project, from the regulated asset base. That project had passed the Regulatory Test, although the final cost of the project was well over twice the cost of the project that passed the test. Under the AEMC’s proposal, such a project (and the resulting overspend) would not be subject to ex-post optimisation.

Re-openers and contingent projects

The AEMC has suggested that provision for capex re-openers and contingent projects that exist for transmission should also apply to distribution network service providers. While the AEMC has noted Professor Littlechild’s advice that lower expenditure risks should be reflected in lower rates of return, the AEMC does not appear to have made any commitment to the implementation of this. We suggest that the AEMC should ensure that its approach to changes in the regulatory incentives on capex is reflected in changes to the allowed rates of return.

In addition, there appears to be no evidence that the AEMC has considered the impact on consumers or other stakeholders on the introduction of the various intra-period adjustments that it is proposing to introduce. Such intra-period adjustments have the

potential to place even further demands on consumer organisations, and their ability to contribute to regulatory debates. Our (collective) ability to effectively represent consumer interests will be even further strained if it is to be extended not just to major price control decisions every five years, but also to intra-period adjustments. Considering the importance that the AEMC has (rightly) placed on more active consumer representation in regulatory processes, this issue merits consideration as part of the evaluation of intra-period adjustment schemes.

Related party margins

We agree with the AEMC's assessment that NSPs should be free to contract with whomever they choose to, and that the regulatory regime should not affect their contracting decisions or choice of service providers. The relevant issue, as the AEMC has concluded and with which we agree, is the charges that consumers are required to bear. The AEMC, while rejecting the AER's proposals, has not however provided guidance on how it intends to deal with the opportunity for service providers to inflate their states costs on account of related party margins.

AER's discretion to develop other incentive schemes

The AEMC has suggested that the AER should have limited discretion to develop other incentive schemes, and that this should be achieved through the use of small-scale pilot schemes. We suggest that this merits further consideration. The effectiveness, or not, of an incentive is unlikely to be established if the scale is small, or the targets and incentive power diminished by the AEMC's desire to constrain the AER's discretion.

Our statement of the problem and our suggestions on solutions

It should be clear from the previous sub-section that we think there is a serious incentive design problem and that the problem is most acute in respect of government-owned NSPs whose cost of capital is likely to be significantly below the allowed rates of return.

We think the solution lies in strengthening the power of the incentive for NSPs to reduce their expenditure from the levels determined in the regulatory decisions. As such we support the thrust of the AER's proposal although we suggest significant further examination of this is warranted. We also suggest that incentives might be differentiated between government and privately owned NSPs in order to account for the difference in their respective cost of capital. Our suggestions on the other subsidiary design issues are set out in the rest of this section.

Forecast or actual depreciation

It is not clear to us why this is an issue. If the problem is insufficiently powerful capex efficiency incentives (as we suggest it is) then there should be a preference for the use of depreciation based on forecast, not actual, capex. We note the submission by the Victorian Government's Department of Primary Industry, which has expressed a preference for depreciation based on actual expenditure in Victoria (where NSPs have consistently spent below their regulatory allowances). However this argument ignores that possibility that the reason why Victorian NSPs have spent below their allowances (to the benefit of Victorian consumers and the NSPs) might be that they have had an incentive to do this, and the use of actual depreciation would diminish this incentive possibly to the detriment of NSPs and consumers.

Ex-post optimisation

We have some sympathy with the arguments presented by the AER against ex-post optimisation (evidentiary burden and investment certainty). However, we also note Professor Littlechild's comment on the use of ex-post optimisation in North America. Certainly the evidence, as presented by Ofgem in its fifth distribution price control decision, is that North American network service providers compare favourably internationally. It merits further detailed assessment whether ex-post optimisation accounts for this in part. We also suggest that there be further detailed analysis of the one instance – TransGrid's MetroGrid project - where the ACCC/AER has implemented ex-post optimisation. What were the evidentiary burdens in this decision, what was the process for decision and to what extent did this ex-post optimisation affect TransGrid's subsequent investment decisions.?

Re-openers and contingent projects

We suggest that the case for greater intra-period flexibility has yet to be made. The AEMC's argument that NSPs have to provide services on demand (unlike the circumstance in contestable markets) is unconvincing. Networks are engineered with substantial redundancy and options invariably exist to defer augmentation or to develop demand-side or supply-side alternatives – the mobile gensets in Queensland being a case in point.

Greater flexibility in the determination of expenditure allowances needs to also take account of consequently lower equity risks, and higher consultation and regulatory process demands. These elements of the issue need to be taken into account in the evaluation of changes.

Related party margins

We agree with the AEMC that what matters is the price that consumers are charged, not whom the NSP contracts with. We also note the inconsistency between the AER's aversion to ex-post optimisation and yet its willingness to apply ex-post optimisation to deal with related party margins. Solutions that involve the use of benchmarks might be explored in greater detail in this area as a way to avoid intrusive contract evaluation by regulators.

RATE OF RETURN FRAMEWORKS

This section responds to the question of the appropriate rate of return frameworks that are described and reviewed in Chapter 5 of the Directions Paper.

Stakeholders statement of the problem

AER

The AER has proposed that the rate of return be determined by it, for electricity and gas distribution and transmission through reviews that it will undertake at least every five years. These reviews will not be subject to merits review. The AER suggests that this will resolve the shortfalls in the current arrangements, which include:

- The ability for DNSPs (in Chapter 6) to determine individual rate of return parameters during each review means that the AER is precluded from assessment of overall reasonableness;
- The ability of DNSPs (in Chapter 6) to cherry-pick WACC parameters during each review;
- That the persuasive evidence test (in Chapter 6) is problematic to interpret.

NSPs

The NSPs disagree with the AER. They consider that the arrangements in Chapter 6 have worked well, although there have been problems attributable to the inflexibility of the quinquennial WACC reviews in Chapter 12.

Consumers, other regulators and state governments

Consumer representatives, including Uniting Care Australia, the Economic Regulation Authority of Western Australia and the Department of Primary Industries in the Victorian Government generally support the AER.

AEMC's directions

The AEMC has generally disagreed with the AER, and generally agreed with the NSPs. The AEMC said:

- The quinquennial review arrangement applicable to TNSPs in Chapter 6A is too inflexible;
- It is not convinced by the AER's argument that there has been cherry-picking of WACC parameters by NSPs;
- It is not convinced that persuasive evidence is a concern as the AER suggests it is.

Comment on the AEMC's directions and our suggestions on possible solutions

This is a complex area, but our view in general is that the AEMC has dismissed the AER's concerns too lightly.

Firstly on the issue of "cherry-picking", this is a loaded word with pejorative connotations and that may be a barrier to an assessment of the underlying issue.

The AEMC has not accepted the AER's concern that NSPs have attempted to use price control decisions as opportunities to re-open and perpetually review WACC parameters to their benefit. Instead the AEMC seems to defend the NSP's attempt to re-open WACC parameters as a noble defence of their right to ensure that *"the rate of return that the AER ultimately decides upon is at least sufficient to ensure that it can attract the funds in the financial markets to undertake investments in its network over its regulatory period"*.

NSPs have a very strong incentive to make every effort to achieve as high a rate of return as they can. A review of the many pages of submissions and argument during each NSP price and revenue control decision is evidence of the great attention that this area attracts. To characterise this attention as the pursuit of the right answer, as the AEMC seems to suggest, is not a reasonable response to this complexity.

The flexibility established in Chapter 6 has means that DNSPs have attempted to re-open consideration of several parameters that have been debated many times and considered often exhaustively in recent decisions. This has consumed resources often for little purpose other than to fend off unreasonable rent seeking from the NSPs. It is not reasonable to point to the significance of the rate of return for NSPs revenues and profitability – as the AEMC does - as justification for the perpetual review of cost of capital parameters as allowed under Chapter 6.

On the issue of inflexibility, the AEMC points to the ACT's decision on gamma and that the Chapter 6A arrangement prevents the implementation of the ACT's decision for TNSPs until the next WACC review. We are not convinced that this is *necessarily* the problem that the AEMC suggests it is. Specifically, the National Electricity Law establishes the ACT as

responsible for reviewing the merit of AER decisions. We dispute however that this means that the ACT's decisions are necessarily right and the AER's necessarily wrong (whether or not it rules in the AER's favour). Most of the significant WACC issues that the ACT has reviewed have required the exercise of judgement on issues that are highly arguable, such as the calculation of the Debt Risk Premium, Gamma and the averaging period for the risk free rates. We generally disagree with their judgements in most of these decisions. On this basis we suggest that characterising the ACT's decisions as correcting "errors" in the AER's decisions is unjustified. It follows from this that we do not support the AEMC's claim that Chapter 6A is inflexible because it prevents these ACT "error corrections" from being reflected in future AER decisions.

In summary, we do not agree with the logic underlying the AEMC's unwillingness to accept the AER's concerns.

However we are also not convinced that the AER has proposed an appropriate solution. In particular we are wary about the absence of any form of merits review of WACC decisions.

We suggest much more work needs to be done to find the appropriate way forward in this area. So far, there has been no consideration, by the AEMC, of the impact of changes on the rate of return framework on consumers, particularly small consumers and their ability to contribute to WACC decisions. The perpetual review that Chapter 6 has engendered has played to the NSP's advantage to the extent that such perpetual reviews have placed even greater strain on consumer's ability to contribute to price review decisions.

The AEMC's discussion has also not encompassed Professor Littlechild's recommendation that changes to the arrangements for the determination of capex (and specifically the AEMC's proposal to allow intra-period capex adjustments) should be reflected in allowed rates of return. More generally we would like to see this issue raised as part of a systematic analysis of the compensation for the risks borne by NSPs under the system of regulation.

The arrangements for the determination of the rate of return are very complex and would benefit from a wider and far more holistic contemplation than the AEMC has so far embraced. Trade-offs need to be found between flexibility, predictability, consumer involvement, fair compensation for risks, and efficiency incentives. We strongly encourage the AEMC to extend the terms of reference of the involvement of Professors Littlechild and Yarrow to also include rate of return issues. We suggest that the AEMC's consideration in this area would benefit greatly from their considerable experience in this area.

Finally, we would like to strongly encourage the AEMC to establish evidence of how the allowed rates of return that have been established under Chapters 6 and 6A and the National Gas Rules compare to the allowed rates of return in decisions by other regulators

in Australia and internationally. Such empirical comparison will, we suggest, be very useful in assessing the need for reforms of these aspects of the regulatory framework.

COST OF DEBT

This section responds to the AEMC's directions on the return on debt described and reviewed in Chapter 6 of the Directions Paper.

Stakeholders' statement of the problem

AER

The AER pointed to several problems with the calculation of return on debt. They suggested that the specification of the return on debt should be excluded from the Rules and should instead be included in the determination of the WACC that the AER would periodically undertake.

EURCC

The EURCC suggested that calculation of the return on debt as specified in the Rules was flawed, and that the actual cost of debt to government and privately owned NSPs was significantly below their allowed return on debt. They also suggested that there is a big difference in the cost of debt of government and privately owned NSPs. The EURCC concluded that the Competition Principles Agreement did not justify government-owned NSPs receiving same return on debt as privately owned NSPs.

On the basis of the calculation of the effective return that jurisdictional governments receive from their NSPs, the RCC proposed that the return on debt for government-owned NSPs should be set with regard to the cost of debt raised by the jurisdictional government treasuries. For NSPs that are privately owned, the EURCC proposed a formulation of the return on debt based on the trailing average yield to maturity of corporate bonds issued in Australia.

NSPs

The NSPs agreed with the AER and the EURCC that there is a problem with the specification of the return on debt. However they disagreed with the AER's proposal that the AER should be allowed to set the return on debt. They also disagreed with the EURCC that the Competition Principles Agreement did not support government-owned NSPs receiving the same return on debt as privately owned NSPs. While many NSPs recognised that the actual cost of debt was below the allowed return on debt, they attributed this to the shorter tenure of debt issued since the GFC. Most NSPs and their representative organisations gave guarded support for the rolling average calculation proposed by the EURCC.

Consumers, retailers and governments

Large business representatives and several large consumers supported the EURCC's proposals. Many of the small consumer representatives did not express a view on the EURCC's proposals but did support the AER being allowed to determine the return on debt. The retailers association and The Queensland Treasury Corporation suggested that the EURCC had overstated the difference between the cost of debt and the allowed return on debt, and the QTC and New South Wales Treasury suggested that the EURCC had overstated the profitability of NSPs to their jurisdictional governments owners. Both Treasury Corporations staunchly defended the rights of the NSPs they own to receive the same return on debt as the privately-owned NSPs. The South Australian Government did not support government-owned NSPs receiving a lower return on debt than their privately owned peers, while the Department of Primary Industries in the Government of Victoria supported some aspects of the RCC's proposals.

AEMC's directions

The AEMC has agreed that there is a problem with the specification of return on debt in the rules. However they seem undecided whether the actual cost of debt is below the allowed return on debt, or to be more precise the AEMC holds open the possibility that if the actual cost of debt is lower than the allowed return on debt then the gains on this for NSPs may be offset by higher refinancing risk associated with shorter term debt that has been raised since the GFC.

The AEMC has agreed with the AER to the extent that they suggest that the return on debt should not be specified in the Rules, but should rather be left to the AER to determine. However, as discussed in the previous section, they disagree with the AER's proposal that the AER's determination of the return on debt should not be subject to merits review.

The AEMC disagreed with the EURCC's proposal that the return on debt for government-owned NSPs should be different to the return on debt for privately owned NSPs. It gave six reasons for this:

- **it fails to recognise that competitive neutrality principles also apply to correct resource allocation distortions that can result in the input as well as output markets of government-owned monopoly businesses;**
- **it does not recognise autonomy of state and territory governments to make policy decisions in compliance with the CPA to corporatise their NSPs and apply commercial disciplines;**
- **it does not factor in the role of the debt neutrality fees as required under the CPA and the legitimate impact it has on the debt raising costs of government-owned NSPs;**

- it will potentially create artificial geographical market distortions in generation and network capacities across the NEM because (of) the pricing signals that would be created due to network ownership;
- it could remove the option of any future sale or other divestiture of government-owned NSPs; and
- it confuses the roles of shareholder and taxing authority arrangements of governments as owners of NSPs.

Comment on the AEMC's directions and suggestions on possible solutions

We disagree with the AEMC's conclusions in this area.

With regard firstly to the response of the AEMC to the AER's proposals, the AEMC has not provided a justification for its thinking that the return on debt should not be specified in the Rules. Specifying the calculation of the return on debt has potential to reduce disputes during price control decisions and provide greater certainty to the industry and its consumers. It may also reduce the need for on-going consumer advocacy during each price/revenue control decision, thus helping to ensure the best use of scarce consumer advocacy resources. The cost of debt is amenable to observation and we can see no compelling reason why the formulation for its calculation should not be specified in the Rules.

With regard to the EURCC's proposals, we are concerned that the AEMC has not addressed the Committee's essential proposition: that the treatment of the return on debt should be evaluated against the National Electricity Objective having regard to the extraordinary profitability of the NSPs to their jurisdictional government owners.

We noted that the AEMC's consultant, SFG, dismissed the Committee's analysis of the profitability of NSPs in New South Wales. This dismissal was based on the New South Wales Government's submission to the Issues Paper, not on SFG's own analysis. We have noted that the EURCC's evaluation of this aspect of the New South Wales submission concluded that their dismissal of the EURCC's analysis could not be sustained. The EURCC's reasoning to support this conclusion was submitted to the AEMC on the 17th of February 2012.

With regard to the AEMC's six reasons for dismissing the EURCC's proposals, we suggest that none of these reasons withstand critical scrutiny. We are particularly concerned that the AEMC has not, in our opinion, met its obligations under the National Electricity Law in its dismissal of the EURCC's proposals in this area. We refer the AEMC to the detailed analysis of this in the EURCC's submission on the Directions Paper.

We encourage the AEMC to reconsider its position in relation to the treatment of the return on debt for government-owned NSPs. Whether or not any premium to the underlying cost of debt should be reflected in the allowed return on debt for government NSPs merits further objective assessment. We regard the forthcoming (in May) forums as a constructive approach.

REGULATORY PROCESS ISSUES

This section responds to the regulatory process and confidential information issues that are described and reviewed in Chapter 7 of the Directions Paper.

Stakeholders' statement of the problem

AER

The AER has complained that NSPs are providing late submissions and are making submissions on their own proposals. The AER suggests that through this they are able to frustrate due process for the review of information by the AER and other interested parties.

With regards to confidential information, the AER is concerned that NSPs are abusing the opportunity to claim confidentiality and through this, is frustrating transparent disclosure.

NSPs

The NSPs say that nothing is wrong; that they should be able to provide the most up-to-date information to minimise the prospect of errors by the AER. They also say that there is nothing wrong with their claims of confidentiality.

Consumers

Uniting Care Australia agrees with the AER on both the regulatory process and confidentiality issues. Through active involvement with regulatory processes, we have been frustrated by the amount of confidential information that is withheld from consumer groups. This limits informed consumer voice in significant decision making and further exacerbates asymmetry in regulatory process.

The AER's proposal reduces the incentives for NSPs to present confidential information, outside of consumer scrutiny, and so is strongly supported.

AEMC's directions

The AEMC has concluded the current process has not worked and that this is attributable to a much greater volume of information than the AEMC had expected. It suggests that greater dialogue (both formal and informal) between the NSP and the AER in the lead up to the AER's draft decision would improve things. The AEMC is not inclined to support the AER's

proposals to restrict NSPs from submitting information to the AER, but will consider 5 five possible options ranging from a new step in the consultation process to restricting the scope of NSP submissions on its own proposals.

On confidentiality, the AEMC is not convinced that there is a problem. It considers that it has sufficient powers under the NEL and common law to use its discretion in determining the weight to be given to confidential information, but the AEMC intends to examine how this works in practice.

Comment on the AEMC's directions and our suggestions on possible solutions

We think this is a straight-forward problem to resolve. We disagree with the AEMC's diagnosis of the problem and their proposed approach to finding a solution.

It seems to us, that the problem here is that the onus of proof lies with the AER to justify its decision against the proposal put to it by the NSPs. As such, whenever an NSP provides information to the AER, the AER is obliged to consider it and ensure that any decision it (the AER) makes, can be justified with respect to the information provided by the NSP. This creates an obvious opportunity for NSPs to use the information provision process in a strategic way to control the amount of time the AER has to review proposals put to it by NSPs, and to frustrate proper consultation processes.

This problem is easily resolved by placing the onus of proof on NSPs to justify their proposals to the AER, rather than the AER to justify their decision against the NSP's proposal. This will correctly incentivise NSPs to provide information on-time and the AER will easily be able to control aberrant behaviour by NSPs (or other stakeholders) by providing advance notice of its intention not to have regard to late submissions. As such, restrictions on NSPs such as the AER has proposed are unnecessary.

On confidential information, if the burden of proof is correctly established, NSPs will have much weaker incentives to attempt to hide information through confidentiality claims. If the onus is on the NSP to convince the regulator, they would presumably wish to make as much information as possible openly available, to convince the regulator of the merits of their proposals. Hiding information through confidentiality claims will undermine the credibility of their proposals to all stakeholders.

We commend these comments to the AEMC, and confirm our availability for further comment and discussion about these issues.