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# Submission in response to proposed changes to the rules governing the economic regulation of monopoly energy distribution businesses

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The Consumer Utilities Advocacy Centre Ltd (CUAC) would like to thank the Australian Energy Market Commission (AEMC) for the opportunity to provide comment on the rule change proposal relating to the economic regulation of monopoly energy distribution network operators. The following submission highlights briefly some of the key issues that need to be considered by the AEMC in determining the appropriate reforms to the rules governing Australia's distribution networks.

At the outset CUAC would like to apologise for the lateness of this submission. We understand that the AEMC has limited time to consider the diversity of evidence and opinion in a rule change proposal. Nonetheless, we hope that sufficient time remains for the AEMC to consider the all-important consumer perspective in its decision making process.

## *The need for reform*

> *The regulatory framework governing transmitters and distributors in Australia is the product of a long reform process. It is also a work in progress.*
>
> Professor Ross Garnaut

At the heart of the rule changes proposed by the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (the Committee) is an acknowledgement of the accuracy of Professor Garnaut's comments on the current rules. It is not unusual for a newly-minted set of regulations to need refinement to achieve its intended objectives and the proposals put to the AEMC illustrate that this is the case for the existing rules. Both proposals, on the back of evidence elicited from the current round of regulatory decision making, provide a compelling case for refinement to the current regulatory structures.

CUAC strongly supports reform to the rules relating to the economic regulation of monopoly energy distribution network service providers. Evidence put forward in both the rule change proposals of the AER and the Committee illustrates some of the major issues with the current rules. It is clear, for example, that the outcomes achieved under the current regulatory framework for electricity distribution businesses have resulted in significant increases in network expenditure compared to previous regimes. Figure 1.7 on page 10 of the AER's rule change proposal highlights the magnitude of the issue. Furthermore, there is no strong evidence that these step changes have resulted in significantly enhanced service quality or reliability.

While some of the increase may be attributed to factors such as regulated reliability standards and network upgrades to manage the increasing of proliferation of renewable and distributed generation, the scale of the increases is not justified by these alone. A further justification for sharp expenditure increases frequently put forward by distribution businesses is the need to replace ageing assets. However, the validity of this argument should be closely examined.

It would seem logical that a prudent business operator would manage assets in such a way that capital expenditure associated with their replacement would occur progressively resulting in a smooth expenditure trajectory. What has occurred does not align with this expectation of prudent management. Instead, both capital and operational expenditure have increased in an inelegant step change that occurred as soon as responsibility for regulation had transferred to the AER. If the ageing assets argument is accepted then one would also need to accept the proposition that a significant proportion of distribution assets in all of distribution areas in the national electricity market (NEM) reached the end of their useful lives coincidentally with the transition to a new national regulatory regime.

The AER in its rule change submission states that:

> *the sharp and significant step change in expenditure forecasts draws into question whether the current framework is meeting the National Electricity Objective (NEO) in 'promoting efficient investment' or whether it is stimulating investment over above efficient levels.*

At a broad level, other commentators have highlighted weaknesses in the current regulatory regime. For example, in his recent Climate Change Review paper *Transforming the Electricity Sector*, Professor Garnaut noted that:

> *There is a prima facie case that weaknesses in the regulatory framework have led to overinvestment in networks and unnecessarily high prices for consumers.*

It is CUAC's firm view that the regulatory framework contains imperfections that need correction in order for it to function in accordance with the consumer interest and the NEO. CUAC is of the opinion that the current regime:

- includes incentives to over-invest;
- allows distribution businesses to receive a return on their debt in excess of its cost; and
- accentuates the information asymmetry between the regulated business and the regulator and consumers.

While not a matter for the current rule change process, it is appropriate for the AEMC to also acknowledge the manifest inadequacies in the current merits review appeals mechanism. The mechanism established under the National Electricity Law (NEL) allows distribution businesses to seek a very limited appeal on the merits of particular aspects of the AER's pricing decision. A recent joint report by CUAC and Consumer Action entitled *Barriers to fair network prices: Analysis of consumer participation in merits review of the AER EDPR* highlights the key issues with the current appeals process including:

- the incentive to "game" the price review process in order to increase the chance of success in a merits review appeal;
- the lack of any disincentive including any financial risk from a decision to appeal a regulatory determination;
- the practical impossibility for consumer perspectives to feature in the appeals process or the Tribunal's ultimate decision.

Given the recent decision at the Standing Council on Energy and Resources (SCER) meeting on 9 December 2011 to bring forward the review of the appeals mechanism to 2012, it is necessary for the AEMC to consider the interaction that any changes it makes to the rules will have with current and prospective appeals mechanisms that may emerge from the SCER review.

## *The rule change proposals*

Given the compelling evidence of incentives to over invest resulting in dramatically increasing network expenditure without corresponding network performance improvements, it seems that there are two questions for the AEMC to consider:

1. Do the proposed changes go far enough to address the clear imbalances in the current rules?
2. Which of the rule change proposals represents the best approach to setting the weighted average cost of capital (WACC)?

With the exception of proposed revised approach to WACC setting, which will be addressed later in this submission, CUAC supports the implementation of all of the proposed amendments to the national electricity and gas rules proposed by the AER. In coming to this conclusion, we have drawn upon our recent experience participating as a member of the AER's consumer forum to provide input to the latest Victorian electricity distribution price determination. As CUAC tested opinions and ideas with the regulator as part of that process, two things became apparent. First, the regulator did not have the discretion to consider compelling ideas and approaches to achieving the most appropriate setting of operating and capital expenditure. Instead, the regulations compelled the regulator to adopt a narrow and conservative interpretation of its powers. Second, the substantial information asymmetry between the regulated and the regulator was exacerbated by the provision (or otherwise) of information in a strategic manner by the regulated businesses. The rule changes proposed by the AER are good start to addressing these two significant issues.

### *Expenditure forecasts*

The proposal to provide the AER with greater discretion in determining the appropriate forecasts for operational and capital expenditure should improve the ability of the AER to take into account the best available evidence in setting expenditure forecasts. CUAC notes that these particular proposals remain modest and reasonable in scope and demonstrate a strong regard for safety and reliability of supply. CUAC notes that the AER has further mitigated any risks associated with the increased discretion by proposing a "reopener provision" for capital expenditure overspends.

The greater discretion provided to the AER under these proposals should allow them to implement a greater use of benchmarking analysis to compare expenditure forecasts between distribution

businesses. Furthermore, the proposals will give the AER greater scope to take into consideration ongoing developments in the field of regulatory economics, as well as innovations used by other energy network regulators.

Consumer organisations need to closely consider the price service mix that is most appropriate for consumers. High supply reliability and quality is valued highly by consumers. If CUAC perceived there to be any serious compromise to supply quality and reliability as a result of the reforms to expenditure forecasting proposed by the AER, we would have trouble supporting such reforms. However, CUAC considers that the approach proposed by the AER in its rule change proposal is in line with international regulatory practice and contains sufficient checks and balances to ensure that service reliability and quality is not compromised. In fact, the proposals will most likely continue to deliver the service standards that consumers expect but at a more efficient cost.

Overspends of capital expenditure have continued to occur under the regulatory regime and there is an incentive for overspend resulting from the ability for overspent capital expenditure to be rolled into the regulatory asset base (RAB). The AER's proposal to disincentivise such overspend whereby only 60 per cent of the value of the overspend is rolled into the regulatory asset base appears to be modest and reasonable. It would appropriately share risk between the regulated business' consumers and its shareholders.

***Improving the regulatory process***

CUAC is also supportive of the AER's proposals in relation to the regulatory process. In order to overcome information asymmetries between the regulator and the regulated, the regulator should be able to access the relevant information it requires, in a form that can be used effectively, whenever it is needed. Furthermore, given the broad public interest in the outcome of the distribution pricing process and the desirability of scrutiny by consumers and their representatives, it is appropriate that information provided by regulated businesses as part of a regulatory process is available for public access and comment.

The AER's proposes to restrict the ability of the distribution businesses to withhold information and avoid accountability by removing their current ability to provide a submission on their own proposal. Such a step is a commonsense approach to removing one avenue currently used to provide information in the most strategic manner possible. CUAC would hope that such a reform would be followed by additional reforms to further address information asymmetries between the regulated businesses and the regulator.

The proposed changes to the current regulatory regime that seek to provide equal treatment to confidential information provided by any stakeholder to the price determination process is a further step in the right direction. CUAC is of the view that all information should be provided to the regulator on the presumption that it is public. For any information that a stakeholder deems confidential, the stakeholder providing that information should have to provide grounds to the regulator as to why the information should be kept confidential and therefore avoid the public scrutiny that is a necessary condition of the regulatory system's transparency.

***A note on prescription versus discretion***

As a general rule, CUAC is positively disposed towards a regulatory regime that sets high level objectives and guidance for the regulator and then provides the regulator with a considerable degree of discretion as to the actual mechanics of their decision-making process. Under such a regime, the high level guidance provides the regulated businesses with sufficient regulatory certainty in order for them to invest with confidence. Meanwhile, the regulatory process can remain dynamic and consistent with international best practice, market trends and additional sources of information. Our confidence in such an approach is underscored by the fact that Australian economic regulators are generally conservative in their application of regulation. Consequently, there is low risk of a regulatory failure where revenues are set at a level below that required to maintain service quality and reliability.

The current economic regulation of distribution networks under the national gas and electricity laws is not such a dynamic regime. Instead, a high degree of prescription is provided for in the rules in a way that constrains effective regulatory practice. Adopting the AER proposals would be a movement toward a more dynamic and responsive regulatory framework for the regulation of monopoly distribution networks. It would go some way to returning to a system such as the successful regulatory framework that operated in Victoria prior to the transition to the national regulator.

The susceptibility of different regulatory framework to merits review appeal should also be heeded. CUAC is firm in its view that the merits review appeal process should be excised from the electricity and gas laws leaving only judicial review as the avenue for reopening a regulatory decision. CUAC will put this position to the review of the appeals process in 2012. However, on the basis of the current appeals process and if merits review is retained beyond 2012, a regulatory regime that provides greater discretion to the regulator should be less susceptible to appeal. This was highlighted by the former Chief Executive Officer of the Essential Service Commission in Victoria in a 2006 speech to the Melbourne University Law School:

> *Experience suggests that... the opportunity to seek judicial review is directly proportional to the level of detail in the actual regulatory and legal framework that governs the regulators task... More discretion provided to the regulator arguably gives rise to less opportunity for appeal. A balance therefore is required as more prescription and detail generates more risk of ambiguity, inconsistency and inflexibility... As we have seen those regulatory frameworks that prescribe in detail the objectives principles, criteria and methods do so knowing that they are incapable of being objectively measured and compared – and therefore invite appeal irrespective of the decision.*

One would hope that appeals of regulatory decision making would become the exception rather than the norm. The current law and rules are not achieving this. The movement towards a more discretionary regime should, therefore, be a welcome movement away from the inevitable litigious aftermath of current regulatory decision-making.

***What is the appropriate approach to the setting of the WACC?***

The question of prescription versus discretion is a key issue in determining the most appropriate approach to WACC setting given the proposals now before the AEMC. The proposal by the Committee provides compelling evidence of the extent to which the both publicly and privately owned distribution businesses receive a return on debt that is far in excess of their actual cost of debt. A prescriptive framework for the setting of the cost of debt is then recommended as the recommended approach to setting the WACC in future regulatory determinations. In contrast, the AER's proposal seeks to give it greater discretion in its approach to WACC setting and remove the current ability of distribution businesses to amend the WACC in the course of their individual price setting process.

The great benefit of the Committee's proposal is that it would set the WACC at a rate that is most appropriate given current market conditions. However, as previously discussed, such a prescriptive approach may increase the likelihood of appeals. The benefit of the AER's approach is that the WACC parameters would be set in a process that would not be subject to merits review appeal and would therefore provide greater certainty, and most likely lower network costs, to consumers.

CUAC has not come to a conclusion as to the most appropriate approach to determining the WACC. It is our view, however, that both proposals would represent an improvement on current process. It is clear the current regime is resulting in an unreasonably high WACC. Furthermore, the current merits review appeals on WACC parameters seem to involve a competition to see who can find the most distinguished expert to engage in debate with another distinguished expert on the most esoteric of topics such as gamma. In such circumstances, there are serious doubts about the ability of a court to make judgments that would represent any improvement on the judgement of the regulator.

We await with interest the evidence presented in other stakeholder submissions to shed further light on the two approaches. We hope to be able to provide further perspectives on this issue as the rule change process progresses.

Once again, CUAC would like to thank the AEMC for the opportunity to provide comment on this important issue. If you have any queries or comments, do not hesitate to contact CUAC's Policy Officer David Stanford on 03 9639 7600 or at david.stanford@cuac.org.au.