Submission to the AEMC on its "Strategic Priorities" Discussion Paper (April 2011)

Submitted 13 May 2011

Introduction

This document is Wesfarmers' submission to the AEMC in response to its April 2011 discussion document on strategic priorities. We appreciate the transparent and consultative approach that the AEMC has adopted in considering its priorities, and we are pleased to be able to contribute our views in this submission.

Wesfarmers and many other entities in Australia have been calling on Australia's governments to adopt a more assertive approach to productivity improvement across the Australian economy. We consider that the AEMC has an important role to play in promoting productivity in Australia's electricity and gas industry, a role that we are keen to see the AEMC pursue with vigour to ensure, to the extent possible, equitable outcomes for all participants in Australia's energy markets.

This submission begins within a brief introduction to Wesfarmers and why Australia's energy market outcomes matter to us. This is followed by a discussion on the economic regulatory framework for monopoly network service providers and the role that we suggest the AEMC should play in a review of these frameworks. Finally we provide specific comments on the AEMC's three priorities as presented in the discussion paper.

About Wesfarmers and our interest in the AEMC's priorities

Wesfarmers is a major diversified Australian public company. Our businesses span a wide cross-section of the Australian economy including retailing (where our businesses include the Coles group, Bunnings, Kmart, Target, Officeworks and Blackwoods), insurance, resources (largely coal mining) and industrial operations in energy processing and marketing, chemicals and fertilizers and industrial and safety supplies. Our annual revenue in 2009/2010 was approximately $52 Billion, we have more than 490,000 shareholders and provide direct employment to approximately 195,000 Australians.

In respect to our direct engagement in Australia's energy markets as a supplier we supply coal for domestic electricity generation in three States (as well as export large volumes of coal as well), we retail (largely bottled) LPG nationally and one of our businesses is an electricity supplier to twenty remote communities and mine-sites, away from the public electricity grid systems, particularly in Western Australia. We also provide bulk LNG as a transport and generation fuel in Western Australia.

We currently spend over $300m buying electricity for our retail and industrial businesses each year, as well generating a significant amount of electricity in our own right. While this may be a small portion of our total cost of sales, this belies its strategic significance to us and to our customers. Our retail businesses all operate in very competitive environments where supply chain efficiency and cost reduction is a continual challenge. Significant rises in the cost of doing business, such as we have seen in recent years for electricity, puts pressure on these businesses. The rising price of electricity also affects our suppliers, amongst them many of Australia's farmers, food producers and many small product and service providers. Our customers will ultimately have to bear higher prices for the goods that we provide if our internal efficiency gains are unable to keep pace with external cost increases. The AEMC will be well aware of the acute sensitivity in Australia to cost of living pressures in general, and rising electricity prices in particular.

Electricity prices have risen at a significant rate over the last few years as shown in Figure 1 below. This figure shows the difference in the annual change in the price of electricity with the change in the Consumer

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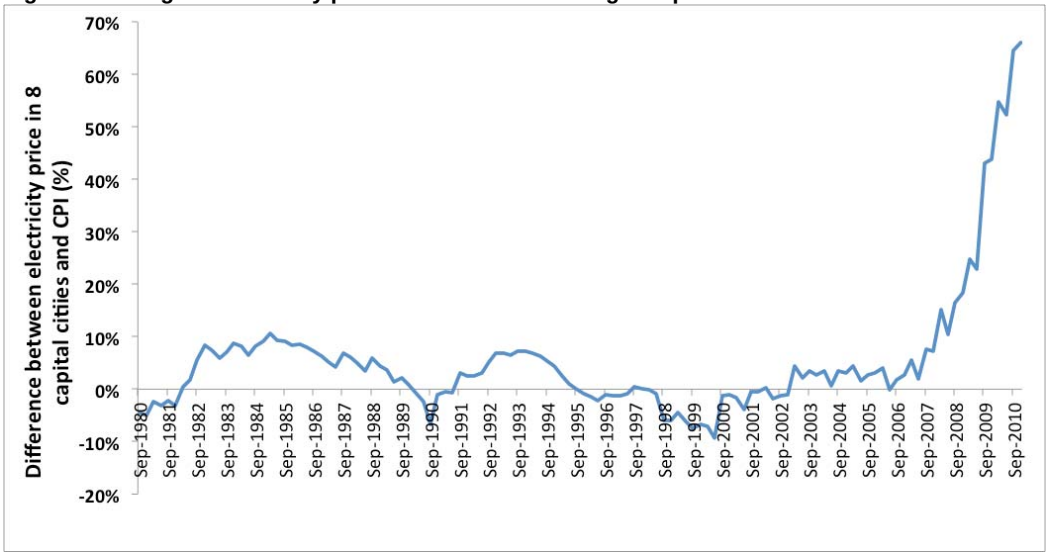
Price Index (CPI), from 1980 (when the Australian Bureau of Statistics started collecting electricity price data) to September 2010. The figure shows that from 1980 to 2008, the price of electricity moved in a band of plus or minus 10% of the Consumer Price Index (CPI). However, since 2009, the price of electricity (as delivered to customers) moved out of this band and has increased by around 60% in real terms. Like all large users we have some ability to create efficiencies with suppliers in open markets but the regulated costs in the system offer no such latitude.

Figure 1. Change in electricity prices relative to CPI in eight capital cities



Source: Australian Bureau of Statistics 6401.0, Table 7, CME analysis.

This price escalation has been one of the major factors in the dramatic deterioration in Australia's productivity over the past decade, with the broadest measure of productivity growth turning negative over the past five years[1]. From 2001 to 2010, the utilities sector (covering electricity, gas, water and waste water) had the most rapid decline in multi factor productivity – about 3.7% per year – of all 12 industry sectors examined by the Australian Bureau of Statistics[2]

Electricity is by far the largest component of this industry sector, and electricity distribution is in turn by far the largest cost component of the electricity industry. A soon to be released research report[3] (a copy of which will be provided to the AEMC) undertaken for the Energy Users Association of Australia (EUAA) [Wesfarmers is a member of the EUAA] found that whereas the average price of *producing* electricity has remained roughly constant over the last decade, in the period from 2001 to 2010 the average annual price of *distributing* it has increased by 3.5% in real terms. Over this period, service performance has remained roughly constant while energy distributed has grown by less than 1.7% per year.

As a public company, operating in many different but competitive markets in Australia and New Zealand, Wesfarmers accepts the need for acceptable profit margins to allow shareholders to receive satisfactory returns, for employment to grow and for there to be continued capital investment in the economy. However the information provided in the preceding paragraphs gives rise to a view that corrections are necessary (particularly) in the electricity markets to ensure economically sustainable investment and market operation on behalf of all participants.

Following a series of decisions by the Australian Energy Regulator (AER) in 2009 and 2010, distributors' allowed revenues in real terms will increase on average in the National Electricity Market (NEM) by 7% per annum for the next four years, roughly double the rate of the last 10 years. This suggests that electricity distribution could become an even more significant factor in Australia's productivity performance over the next five years than it has been for the last decade.

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[1] Eslake, S. and Walsh, M. 2011. "Australia's productivity challenge". Grattan Institute, Melbourne. Page 4.

[2] Ibid, page 23.

[3] Mountain, B.R., May 2011. *"Australia's rising prices and stagnant productivity: the contribution of its electricity distributors"*. Energy Users Association of Australia, Melbourne.

Should the economic regulatory framework for monopoly network service providers be reviewed?

We have noted that the AEMC has concluded – we understand reflecting advice from the AER – that distribution cost increases are attributable to demand growth and ageing assets amongst other factors. The EUAA's commissioned research mentioned above provides[4] evidence to suggest that these explanations are only part of the explanation, but not the full story. We understand that the report on this research has been sent to the AEMC, and is available from the EUAA's website. It may be helpful to draw out some of its key findings:

- annual revenues per connection for government and privately owned distributors were approximately equivalent in 2006 (at around $700 per connection per year). By 2014, government owned distributors will be recovering twice as much revenue per connection as privately owned distributors in very similar markets;
- by 2014, the regulated asset base per connection served by government owned distributors will be three times as much as it will be for privately owned distributors;
- in 2014, regulated assets of government owned distributors will be valued twice as high per kilometre of line as those of privately owned distributors.
- the government owners of distribution networks in New South Wales and Queensland have projected, in their State Budgets, significant increases in dividends and income tax equivalents and attributed this increase to expansion of the regulated asset base.
- based on an international survey[5], the AER is one of a small number of regulators that do not use or are not actively considering the use of advanced benchmarking techniques in analysing the efficiency of gas and electricity network companies." The AER's decision to not maximize the use of benchmarks in its efficiency assessments is likely to be a significant factor limiting its ability to constrain inefficient expenditure by distributors.
- if the allowed rates of return, per unit asset valuations and the efficiency of Australian distributors was equivalent to their peers in Great Britain, average electricity prices would be around 25% lower in Victoria, 35% lower in South Australia and 50% lower in New South Wales and Queensland. Wesfarmers well recognizes that Great Britain is geographically smaller, and in general terms more densely settled than the NEM market areas, but believes that these disparities, particularly in Australia's more populous States, do reflect some legitimate cause for review of Australia's regulatory outcomes.
- ageing assets does not explain the higher expenditure by distributors. The *average remaining useful life* of the assets of government owned distributors is 31 years, while it is 22 years for privately owned distributors. If asset ageing was a legitimate concern then based on remaining lives it should be expected that privately owned distributors would be spending more to replace ageing assets than government-owned distributors (as their assets are in general closer to "retirement"). However, the opposite is the case: the AER decisions have allowed government owned distributors to spend more than four times as much per customer as privately owned distributors to replace assets.
- similarly, rising peak demand and growth in connections does not sufficiently explain higher expenditure in our view. We understand demand and connection number growth has been higher in Victoria than in Queensland and much higher than in New South Wales, and yet distributors in New South Wales and Queensland have been allowed to spend up to four times as much per customer to meet demand growth than Victorian distributors.

In summary, there is now a substantial body of detailed research, which when aligned with our experiences, suggests that the considerable expansion in electricity distribution costs in the NEM is largely attributable to ownership, the design of the regulatory framework and the conduct and decisions of the regulatory system within that framework.

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[4] Ibid.

[5] Pollitt, M.G., Haney, A. B., 2009 *"Efficiency Analysis of Energy Networks: An International Survey of Regulators"*, Electricity Policy Research Group Working Paper 0915, Cambridge Working Paper in Economics 0926, University of Cambridge.

In making this point Wesfarmers does not specifically criticise the AER or Australian Competition Tribunal for their regulatory decisions, as the NEM rules framework is very complex and inflexible. There is now significant support for the view that system ownership; flaws in the design of the regulatory framework and the conduct and decisions of the regulatory system within that framework largely explain the significant increase in distribution costs in recent years. We note in particular the views on this expressed by Professor Garnaut[6], Professor Tom Parry[7] (previously the Chairman of the New South Wales Independent Pricing and Regulatory Tribunal (IPART) and currently the Chairman of the Australian Energy Market Operator AEMO) and Mr Rod Sims[8] (currently Chairman of IPART and nominated Chairman of the ACCC).

Our strong view, based on this evidence and on our own experience as a major buyer in Australia's energy markets, is that flaws in the design of the regulatory framework and its implementation can explain much of the higher monopoly distribution costs that all users are being forced to bear. The extent of price rises already incurred (and yet to be incurred as a result of previous regulatory decisions) points to the need for urgency in reviewing and revising, as becomes necessary, the regulatory and legal systems supporting the NEM so that these flaws can be thoroughly tested and resolved in a transparent process.

What role should the AEMC play in the review of the regulatory framework for monopoly network service providers ?

It will be clear from our submission to this point, that we think that the significant flaws in the economic regulatory arrangements and their implementation, need to be addressed. We have given some thought to the role that we think the AEMC could play in this process.

At first sight, the AEMC's role as advisor to the Ministerial Council on Energy (MCE) would suggest that the AEMC should play a leading role in proactively leading a review of the regulatory framework, advising the MCE on the findings, and proposing and prosecuting changes as necessary to the National Electricity Rules or indeed recommending and advising on required legislative change. On this reasoning, rectifying the flaws in the economic regulatory frameworks should be one of the AEMC's strategic priorities.

However, on further consideration, we are not convinced that this is the most appropriate role for the AEMC at this point. This is partly because of the AEMC's historic role in the development of the framework (we understand the AEMC revised Chapter 6A of the National Electricity Rules for example). As such it is inevitable, that the AEMC may not be perceived by all to be an impartial advisor or arbiter in such a process. More significantly, we are concerned that the AEMC should not fetter its discretion in the assessment of applications by interested parties to change the National Electricity Rules. If the AEMC expresses its own views on these Rules in the context of an AEMC-led review, this may prejudice the AEMC's ability to impartially assess the applications by others for changes to those Rules.

We understand that the AER is currently undertaking its own internal review of the regulatory framework and intends to brief the MCE on the outcome of this review. We understand that one possible outcome being contemplated from this is that the MCE will then direct the AEMC on possible Rule changes. Wesfarmers, in association with a number of other major energy users, is undertaking a similar review of parts of the existing regulatory framework and may in the future also seek to discuss relevant issues with the MCE and make application to the AEMC for Rule changes. It would therefore be very important to us that the AEMC is, and is seen to be, an impartial assessor of Rule change applications that we, and others, might bring to it.

For these reasons, we agree and think it is appropriate that the AEMC has not included a review of economic regulatory frameworks as one its strategic priorities in this discussion paper. We would however encourage the AEMC to develop its own primary research to analyse the outcomes of the existing framework and hence contribute to the public debate and potentially to a deeper understanding of the factors that have led to the outcomes seen over the past few years.

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[6] Garnaut Climate Change Review Update 2011. "Transforming the electricity sector, *Update Paper 8*".

[7] For example see The Australian Newspaper, 31 March 2011. *"Ross Garnaut's carbon pricing plan naïve say producers"* http://www.theaustralian.com.au/national-affairs/ross-garnauts-carbon-pricing-plan-naive-say-energy-producers/story-fn59niix-1226031035687.

[8] For example, Ipart, April 2011. "Changes in regulated retail electricity prices from 1 July 2011, Draft Report". Pages 81 to 85.

Specific responses to the AEMC's three priorities

Predictable regulatory and market environments

The AEMC has identified as its first strategic priority, the implementation of a predictable regulatory and market environment for rewarding economically efficient investment. The discussion paper suggests that the AEMC will provide advice to "*help ensure that the wider environment for investment (in generation) is as predictable as possible*". The AEMC has also emphasized the importance of stable policy.

We support investment in generation as this promotes competition. It is hard to argue with the benefits of predictable and stable policy in promoting such investment. Businesses of all types, including ours, desire stable and predictable environments in which to make investment decisions. However, we are wary about the pursuit of "investment certainty" as a policy priority above others. For example, in the major review by the AEMC of Chapter 6A of the National Electricity Rules in 2005/2006, a major objective was to improve investment certainty for monopoly network service providers. It could be argued that this has played a major role in the significant network expenditure increases with consequential price increases of the past few years and the productivity declines described earlier.

We are also wary about arguments to leave policies and regulations unchanged in order to promote stability. Significant failures should be rectified through a proper public process as a matter of appropriate urgency once they become apparent.

Rather than investment certainty and stability, we suggest that the priority should be to ensure effective risk allocation. Risks should be allocated to the party that is best able to bear those risks. This is particularly important with environmental markets that are legislated to favour one outcome over another – such as the Large Scale Renewable Energy Target (LRET) and proposed policies for carbon emission reduction markets. Sovereign and political risks associated with changes to targets and objectives should reside as far as possible with the government, rather than being passed on to market participants and hence on to electricity consumers. This does not mean that we expect that the government will carry the cost of emission reduction or renewable electricity subsidies. This means ensuring, as far as possible, that governments bear the political and sovereign risks associated with their renewable energy and climate policies. Generation subsidies, transmission access, emission reduction and possible compensation schemes should be designed with this in mind.

Capturing the value of flexible demand

The AEMC proposes to pro-actively identify and remove barriers to effective demand side participation. We support this as well as supporting the AEMC's more wide-ranging demand side participation (DSP3) review. A particular issue that we feel has not been sufficiently examined to date in the demand side debate in Australia is the role of network service providers and specifically the regulatory framework that they operate under.

In particular, we suggest that the regulatory framework provides asymmetrical incentives to network service providers to invest in network infrastructure rather than to seek out demand reduction or demand avoidance opportunities. We recognise that this is a very complex regulatory, commercial and organisational issue, however we can point, for example, to the success that has been achieved, particularly in California, in this area. In the NEM, the debate on demand side participation has been protracted and unresolved. We support the AEMC putting forward bold and decisive proposals to, at last, ensure far greater demand-side participation in energy markets.

Should the AEMC wish to hear more detail on our views on this matter, as a significant energy user in many businesses that practice demand side management and implement energy efficiency technologies and systems, we would be pleased to discuss the issue in greater depth.

Ensuring the transmission framework delivers efficient and timely investment

We understand that the AEMC's focus is on transmission networks, although it has briefly alluded to the regulatory framework for transmission *and* distribution network service providers. We did not get a clear sense from the discussion document what the AEMC is proposing to do under this priority, but we are aware of a number of different focus areas, projects and work-streams. Our specific comments on these are as follows:

- we consider that it would be helpful if the AEMC's work on the assessment of Total Factor Productivity (TFP) was situated within a wider assessment of the economic regulatory framework. TFP is but one of many potential regulatory design options, and its assessment should be situated in that context;
- we are aware the AEMC may at some point consider rule changes for distribution planning standards. Our view is that such changes should not be prescriptive, and that the price to be paid for NEM-wide consistency is not adoption of the lowest common factor. In addition, we believe that the AEMC should ensure that some form of economic assessment is made in deciding network planning standards;
- the AEMC is currently processing rule changes flowing from the energy markets framework review. Our view is that the AEMC should seek out opportunities to reduce the scope of monopoly service provision. Where monopoly is unavoidable, our hope is that the AEMC will investigate opportunities to promote competition for the market through, for example, competitive tenders;
- with respect to the transmission frameworks review, we agree with the importance that the AEMC attaches to this review. From our perspective, the most significant issue in this review is the design and implementation of the arrangements for economic regulation that includes of course the manner in which technical issues are assessed and decided upon. From our reading of the AEMC's transmission frameworks review directions paper it appears that the AEMC is not placing significant importance on this. We would strongly urge the AEMC to ensure that this becomes a more important part of this review.

We trust that these comments are of value to the AEMC in your important task of playing your part in Australia's energy markets. Whilst we have made several comments here in respect of the operation of those markets and various regulatory processes, the importance of stable, consistent and efficient supplies of energy into Australia's economy in ensuring our national prosperity cannot be overstated. Should you wish to discuss any of these issues in greater depth we will be pleased if you could contact either Alan Carpenter (Executive General Manager, Corporate Affairs – tel: 08 9327 4267) or Cameron Schuster (Sustainability Manager – tel: 08 9327 4423).

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