energysafe VICTORIA

26 February, 2010

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
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Dear Dr Tamblyn,

RE: Energy Safe Victoria – Response to Preliminary Findings Paper EMO0006

Thank you for the opportunity to provide comments on your Preliminary Findings Paper.

I have limited myself to those aspects of the Paper that deal with the incentive for service providers to innovate. As you are aware the question of innovation within the electricity distribution industry and the incentives that exist for businesses to pursue step changes in technology has also been a focus of the Royal Commission into the February 2009 Victorian Bushfires. Evidence has been heard and submissions advanced that goes to this and other issues relating to how the economic and safety regulatory regime has and should contribute to minimising the risk further of a repeat of the devastation of the Black Saturday 2009.

I am encouraged that in the summary one key finding is that a TFP methodology will increase the incentive for service providers to be innovative. However, the body of the report contains analysis and a number of observations that are not consistent with this key finding. I will address that concern and also suggest that the analysis supporting the finding would be strengthened if AEMC consider in greater depth the implications cost of service methodologies have for industry structure and not just the firm. Incentive in this context is the incentive to respond to the profit opportunities across the full value chain of the industry – not just the regulated returns to individual natural monopoly networks. This is why TFP has more potential than Building Blocks to deliver outcomes consistent with MCE's broader energy objectives – including promoting energy safety.

In Chapter 2, Promotion of Efficiency under a TFP Methodology, the Paper notes that one dimension of efficiency is dynamic efficiency. The analysis is, however, limited to mainly static efficiency concepts including how businesses seek cost savings, timing issues and the relationship between the business and regulator in identifying and passing productivity gains, in the form of lower network costs, on to consumers. Most of this analysis is worthy but there is little discussion or analysis of how industry and firms create new products and services and how they and the community benefit from them. In short, the paper appears to be limited to an analysis of TFP in a purely regulated monopoly context. Indeed in the final paragraph of section 2.1.1 the regulated networks are characterised as having to *respond* to the challenges of CHP, distributed generation, micro generation, smart meters etc.

A better way to think about this issue is to examine why businesses do or do not adopt these technologies and pursue these opportunities themselves. A regulatory regime and industry structure that facilitates the pursuit by regulated networks of profitable activities within the competitive generation and retail markets would provide such an incentive. Thus, it is more likely that network businesses would pursue Smart or Active Grids when they have strong incentives to pursue profit opportunities across the full value chain of the industry, including managing losses, managing demand and selling energy services. A further analogy relevant to ESV's interests might be a regulated network that offers Renewable Remote Area Power options (RAP) instead of replacing an existing technology such as SWER at the end of its life. RAP facilities by their nature involve an investment in providing an integrated energy service and being exposed to a notionally competitive market. Advancements in local generation technologies (including solar, fuel cells etc) are making the economics of these technologies more feasible. However, most regulated monopoly networks, their financial structures and shareholder expectations

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are not attuned to or desire to be exposed to competitive markets – yet it is the competitive markets (and regulatory methodologies that mimic competitive markets) that contain the most powerful incentives to innovate and be rewarded for effort and risk.

A business that is focused solely on regulated distribution will often find that distributed generation is more trouble than it is worth. Unless it can access the wholesale and retail energy benefits the Network is exposed to reduced sales, more complex network planning issues, more difficult protection arrangements – even if the cost is passed through to customers including the connecting customers – all things that would be better solved if the business was integrated in its business focus and decision making. The key issue that must be addressed by AEMC in its review of the Victorian Government's Rule Change Proposal is the extent to which the existing cost-of-service and rate of return approach has contributed to that changed focus and by implication reducing the available incentive.[1] The related issue that must then be examined is why TFP (and not building blocks) facilitates efficient integration (or reintegration) without diminishing the ability to regulate for open access.

Arguments consistent with the views espoused above were effectively dismissed in the Paper in Section 2.1.4 "Other arguments for the promotion of innovation under TFP". I urge you to reconsider the analysis and observations contained in this section against the actual experience of Victoria since privatisation and first principles of corporate finance outlined below.

The building block approach is essentially a lagged cost of service form of regulation functionally comparable to traditional rate of return regulation as practiced in the United States.[2] Firms (equity) regulated under a cost of service or rate of return regimes are considered to be yield stocks and offer capital growth largely consistent with long term growth in their rate base. Shareholder value is consistent with the out-turn rate of return which is, over the longer term, largely a function of the underlying regulated return and any excess (or deficiency) in retained intra period profits.

A cursory observation of capital markets across the world will show that on average, regulated businesses are able to sustain higher levels of leverage than those businesses operating in more competitive "risky" markets. The uncertainty associated with innovation, R&D etc, which one sees in industries such as pharmaceuticals requires higher rates of return and by implication higher levels of equity (lower gearing). This is also borne out by the fact that the second and third generation of owners of Victorian distributors publicly stated their preference to invest in stable rate of return or yield stocks. The largely Asian investors were used to and more comfortable with rate of return environments. These investors publicly articulated their desire to invest in regulated network businesses and not be exposed to the greater risk and volatility of earnings associated with the competitive retail and wholesale markets. Evidence of this can be found in numerous stock exchange announcements as well as the subsequent sales transactions which saw the spinning off of the retail businesses associated with the original 5 Victorian Distribution Businesses and the winding down of many of the "non-core" business activities.

All Victorian Distribution Businesses were sold for prices considerably in excess of their RAB's i.e. $8.3B versus $3.8B during the mid 90s. Many of the re-sales achieved similar valuations or valuations in-excess of their underlying RABs. A component of those valuations was achieved by adopting more highly leveraged and often complex finance structures. The imbedded and therefore "real" gearing was often in excess of the total RAB. The combination of higher geared entities and the subsequent partial selling down to listed infrastructure entities contributed to an even greater focus on maintaining short term cash yields to sustain the valuations of these listed entities. In discussions with the ESC over a number of years various ratings agencies and credit wrap entities expressed concern at the gearing levels and a fear that the regulator would re-adjust the benchmark regulatory gearing in the WACC calculation closer to that evident in the actual financial structures being adopted. The ratings agencies and the Paper confuse actual gearing levels with the concept of benchmark gearing for a hypothetically efficient firm.

[1] These issues were canvassed in an article "From Stockdale to stocktake: Privatisation and deregulation of the Victorian electricity Industry" CEDA Growth 50 December 2002.
[2] Letter to ORG from Daniel Fessler – Former President of the California Public Utilities Commission September 21, 1998.

It is self evident that an entity focused on generating cash will limit investment to core business, spend the minimum on capital consistent with meeting regulatory obligations and generally minimise the "retained " cash available for expansion, especially in speculative or higher risk ventures. This is particularly the case when credit is short as evidenced during the GFC and its aftermath. This experience is also consistent with the other trends such as funding a greater proportion of new customer connections/augmentations through customer connection charges rather than through prices. The most recent AER and ESC comparative reports attest to this fact. One business has even gone as far as dramatically reducing its programmed replacement of low pressure gas pipes because of an ostensible inability to both meet shareholder requirements for cash and the undertakings made to both Victorian Safety and Economic regulators. The preliminary conclusion of the AEMC - that analysis or evidence does not support the ESC observations concerning the impact of leverage and risk averse management styles - should be re-examined.

The AEMC has misconstrued the argument in relation to cost allocation. In its mature form, regulating the natural monopoly component under a TFP regime mostly obviates the need to be concerned with misallocation of costs across competitive and regulated elements of the business. Under building blocks the tension over cost allocation is central to determining cost "levels" and will again become an issue in Victoria as the AER considers the prices for the mandatory roll-out of meters. The mathematical basis for demonstrating that cost allocation is substantially reduced under TFP (cost trends) as against building blocks (cost levels) has been provided to AEMC previously. The ability to influence a "trend" through cost misallocation is muted relative to building blocks even when there is only one company in the index. The fact that some sort of P0 adjustment may be required in the transition is not a reason to discount this very important longer term benefit of TFP. The reference to side payments in 2.1.4, whilst acknowledged, will only serve to undermine the incentive for businesses to pursue these opportunities in their own right as well as reinforcing the cost of service mentality.

In conclusion, I encourage AEMC to rethink its assessment of the incentives for long term innovation and dynamic efficiency. As Victoria's Energy Safety Regulator, former CEO of the Essential Services Commission and former senior executive employed within the Energy Industry, it is my considered opinion and experience that TFP together with other refinements to the service incentive schemes will offer a far greater long- term potential to bring about the alignment of business and community interests than is currently acknowledged in the Preliminary Findings Report. This includes improving safety outcomes including minimising further, the risk that electricity assets will cause bushfires.

I welcome the opportunity to discuss any of the matters raised in my letter.

Yours sincerely

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