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By email: ec.sen@aph.gov.au

Committee Secretary
Senate Standing Committee on Environment and Communications
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Sir/Madam

The performance and management of electricity network companies

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to provide a submission to this inquiry.

This submission does two things. First, it outlines a history of the development and application of network price determination rules. Second, it identifies a number of current and future issues for consideration to ensure the framework for regulating electricity network businesses better protects consumers.

Electricity network businesses are monopoly, for-profit businesses. Given this, and given investors expect the highest returns on investments, it should not be surprising that network businesses will seek to maximize their returns. In most markets, competition and consumer demand plays a mediating role ensuring that businesses are not able to profiteer or be inefficient. If they do so, a competitor will take their business. In monopoly markets like electricity networks, regulation is required to play this role. As such, the effectiveness of that regulation is important. Whether regulation is effective is dependent on whether it can play the same role that consumers play in competitive markets.

The history of the development and application of network price regulation outlined demonstrates that consumer interests have not been placed at the centre of decision-making at key points—during policy development, rule-making, price determination processes, and appeals processes. We conclude, however, that it is the policy and rule-making areas that have most limited the regulator, the Australian Energy Regulator (**AER**), making decisions that protect consumers by ensuring prices are no more than is efficient or necessary.

The current and future issues raised include:

- the adequacy of consumer consultation and input into rule-making and regulatory decision-making;
- institutional arrangements, and the effectiveness of market governance;

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- challenges to the business models of network businesses, including:
    - likely market developments following pricing rule changes and technological developments; and
    - the need to write down the value of assets in light of changing role of networks; and
- alternative regulatory arrangements, such as 'negotiated settlements'.

About Consumer Action

Consumer Action is an independent, not-for-profit, consumer organisation based in Melbourne. We work to advance fairness in consumer markets, particularly for disadvantaged and vulnerable consumers, through financial counselling, legal advice and representation, and policy work and campaigns. Delivering assistance services to Victorian consumers, we have a national reach through our deep expertise in consumer law and policy and direct knowledge of the consumer experience of modern markets.

Since 2003, Consumer Action has received funding from the Consumer Advocacy Panel to undertake consumer advocacy in relation to national energy policy and regulatory processes. Over this time, we have provided consumer input into important reviews and processes relevant to the regulation of network businesses, including the framework for the economic regulation of network service providers, the framework for reviews of network determinations, and processes monitoring the adoption of new smart metering technologies in Victoria. We have also been heavily involved in the development of retail consumer protections in the market.

History of the development of network price determination rules

<u>Development of the National Electricity Rules (chapter 6)</u>
Prior to national regulation, Consumer Action was involved in the Victorian network price reviews undertaken by the Essential Services Commission. In 2004, the Australian Energy Market Agreement committed National Energy Market jurisdictions to move from state-based setting of network prices to a national framework.

The prices charged by network businesses were first regulated nationally through the adoption of Chapter 6 of the National Electricity Rules in 2007. These rules on the economic regulation of distribution businesses were made by the (then) Ministerial Council of Energy, following public consultation. Due to the technicality and specialisation of the subject matter, primary participants in the consultation were members of the industry rather than end-users.

Despite that, a key concern raised by consumer groups at the time was the detailed prescription in the new rules. This prescription was said to be required to restrict the discretion of the AER as a regulator. The view of some policy makers and the Australian Energy Market Commission (**AEMC**) was that without this prescription it would be open to the AER to limit network allowances to levels below efficient costs, risking the financial viability of some businesses.

The concern raised by consumer groups was that the rules would instill a presumption that the regulator would be required to accept a proposal offered by a service provider, rather than being given the opportunity to set prices at an efficient level. While the ultimate decision-making framework became known as one that was 'fit for purpose', the policy decision appeared to place

primacy on reducing risk and increasing certainty for network owners, rather than promoting the long-term interests of consumers.

The prescription also presented other significant challenges to consumer groups, particularly in understanding the operation of the laws and rules. In a number of cases, Consumer Action was required to turn to specialist legal advisers to understand that effect of the rules. This inaccessibility played itself out in the reviews that followed.

Victorian Electricity Distribution Price Review and Appeals

Consumer Action together with other consumer organisations provided detailed submissions to the 2011-2015 Victorian electricity network price review. This was a priority for our centre because we saw that it was critical that end-user interests, which would drive competitive and efficient costs in an effective market scenario, should also drive outcomes in the proxy regulated price review process.

A key concern raised by our submissions was that distribution businesses provided forecasts to the regulator in previous reviews that far underestimated their revenue and overestimated their expenditure compared with actual revenue and expenditure. This means that consumers ended up paying much more than necessary, fair or efficient for the reliable supply of electricity.

The other issue raised was the level of the weighted average cost of capital, or the regulated rate of return. This amount is important in price determinations and represents the investor's opportunity cost of taking on the risk of putting money into a business. The networks argued that the global financial crisis meant that this rate should be much higher than previously set. Consumer groups put forward evidence, unsuccessfully, that the latest market data did not support the position of the distributors.

In its final decision, the AER agreed to a 45% increase for capital expenditure and 32% for operating expenditure compared to the previous regulatory period. Our concern was that these increases would result in a material increase in electricity prices for Victorian households. After the determination, our view was that the central problem was the rules that the AER had to apply—as noted above, these rules limited the AER's ability to amend the proposals put forward by network businesses.

Despite these large price increases, each of the regulated distribution businesses appealed the AER decision. So as to ensure that consumer views were put forward to the Australian Competition Tribunal that heard the review, Consumer Action joined with the Consumer Utilities Advocacy Centre to intervene in the appeal. Despite putting significant resources into the intervention, ultimately senior counsel advised us to withdraw, citing the immense task in producing new expert evidence to counter that of the energy businesses and the adverse costs risks that could have financial implications for our organisations. It has been estimated that appeals of AER determinations of revenue allowances has resulted in $3 billion additional being paid for by consumers.[1] The success of these appeals suggested that it wasn't so much the AER's decisions, but the poor rules that enabled businesses to recover so much money.

[1] Professor George Yarrow, Hon Michael Egan & John Tamblyn (2012), *Review of the Limited Merits Review Framework – state one final report*, available at: http://www.scer.gov.au/files/2012/06/Stage-One-Report-to-SCER-29-June2.pdf .

Adoption of smart metering technologies

While the network allowances in Victoria increased during this period, an additional significant impact on network prices was the Victorian Government's decision to mandate a rollout of smart meters. The rollout was presumed to have a net benefit to consumers, but a 2011 review of the program found that it will result in net costs of $319m to Victorian customers.[2] Costs of the program were far higher than initially proposed, and benefits of the program are yet to be realised. Much of the presumed benefits rely on consumers engaging with innovative tariffs and thus using electricity more efficiently—yet, in late 2014, only around 6,000 customers had chosen 'flexible tariffs'. The biggest issue with this program was the prioritisation of industry needs ahead of consumer needs during the rollout, driven by poor program governance and government oversight.[3]

AEMC review of network price determination review

In 2011, following the first round of distribution network price determinations, the AER proposed to change the Chapter 6 rules. The change was designed to give it more power and discretion in the rule change process.

One of the key issues of debate was the existing rule that required the AER to accept expenditure proposals from businesses if it was satisfied they 'reasonably reflect' efficient, prudent and realistic expenditure. The expression 'reasonably reflects' recognises that there may be more than one expenditure forecast that is efficient, prudent and realistic. Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leave the evidentiary burden on the AER to prove that the proposed forecast is not efficient and not prudent. Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operated to exclude the AER from setting that lower forecast. Further, even if the AER considered a proposal was too high, it could only amend a proposal by 'the minimum extent necessary' for it to be approved under the rules. The AER also had to base its substitute on the original proposal, restricting the AER from making an overall assessment about what is reasonable.

The AEMC ultimately did change the Chapter 6 rules.[4] The changes were designed to enable the AER to interrogate, review and amend expenditure proposals submitted by network service providers. The AER could also make better use of benchmarking, reviewing the relative efficiencies of network businesses. The recent draft determinations in relation to the NSW energy distribution businesses are the first time these new rules have been applied by the AER.[5] The fact that the AER reduced the businesses' proposals by over $6 billion suggests it has greater power under the revised rules.

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[2] Department of Treasury and Finance (2011). *Advanced metering infrastructure cost benefit analysis*. Undertaken by Deloitte for the Department of Treasury and Finance. Accessed at: http://www.smartmeters.vic.gov.au/__data/assets/pdf_file/0003/138927/Deloitte-Final-CBA-2-August.pdf.

[3] Victorian Auditor General (2009). *Towards a 'smart grid' - the roll-out of Advanced Metering Infrastructure*. Accessed at: http://www.audit.vic.gov.au/publications/2009-10/111109-AMI-Full-Report.pdf.

[4] Australian Energy Market Commission (2012), *Economic Regulation of Network Service Providers – Final determination*, available at: http://www.aemc.gov.au/Rule-Changes/Economic-Regulation-of-Network-Service-Providers.

[5] Australian Energy Regulator (2014). *Draft determinations for NSW, ACT and Tasmanian distributors*. Available at: http://www.aer.gov.au/node/28551

Review of merits review framework

As noted above, the ability of businesses to appeal AER decisions also drove higher prices. When the appeals framework was first developed in 2006, consumer advocates argued that there should not be merits review of energy price determinations, but rather businesses should have to use more limited judicial review avenues if they were dissatisfied with the independent regulator's determinations. A key argument advanced was that energy distribution businesses were corporations rather than individuals, and thus did not require the protection of a merits review framework. Despite these concerns, the law adopted an appeal system friendly to energy businesses.

Following our efforts to intervene in the Victorian electricity price determination appeals, we released a report, *Barriers to Fair Network Prices*, which outlined the problems with the appeals system.[6] Problems included the difficulties consumer organisations had in participating in the appeals system, but also the appeals system itself—distributors could "cherry pick" parts of an AER determination to appeal that they thought they could win, inhibiting the appeal tribunal to look at the determination in total.

Following the publication of our report, the Standing Council of Energy and Resources established a review into the appeals system. Ultimately this review recommended that the only basis of appeal should be whether there is an overall materially preferable decision that could be adopted, and that such a decision is one that best serves the long-term interests of consumers.[7] This recommendation was largely implemented through changes to the national energy laws, significantly changing the 'risk/reward' calculation of businesses considering an appeal. We hope that the reform will significantly reduce the number of appeals.

Summary

This history of energy network regulation outlined above demonstrates that at key points—particularly during initial policy development and rule-making—the interests of consumers were not the priority but were rather secondary to industry interests. This resulted in consumers paying significantly higher prices than were necessary. More recent reforms (to the rules regarding economic regulation of networks, and to the merits review framework) have provided greater focus to consumer interests. We submit that these rules must be given the opportunity to be applied to consider whether they achieve their aims of promoting the long-term interests of consumers.

Current and future issues

Consumer consultation and input

A key problem driving a poor focus on consumer outcomes during earlier energy policy making and regulatory reform was a failure in consultation with consumers groups. Any future reforms to the energy markets must demonstrate strong consumer consultation and input, or the decisions risk benefiting vested over the public interests.

[6] Consumer Action Law Centre and Consumer Utilities Advocacy Centre (2011). *Barriers to Fair Network Prices*. Available at: http://consumeraction.org.au/wp-content/uploads/2012/04/Barriers-to-Fair-Network-Prices.pdf.

[7] Professor George Yarrow, Hon Michael Egan & John Tamblyn (2012), *Review of the Limited Merits Review Framework – state one two report*, available at https://scer.govspace.gov.au/files/2012/10/Review-of-the-Limited-Merits-Review-Stage-Two-Report.pdf.

The AER's Challenge Panel is one such mechanism. We submit that it has been a welcome addition to the regulatory framework, prioritising consumer advocacy in the AER price determination process. We submit that following the current round of price resets, the Challenge Panel should be reviewed to determine the extent of its impact on AER decision-making. There is a current lack of transparency about the role and impact of the Challenge Panel, and it's important that it not be relegated to 'window dressing' in a regulatory framework that prioritises the interests of businesses.

A new consumer body, Energy Consumers Australia, will also be established in 2015. It will undertake its own advocacy as well as provide grants to other consumer bodies to undertake research and advocacy. It will be important for Energy Consumers Australia to be independent of government and the industry, and be accountable to consumers. Recognising there is no one consumer voice, it needs to also support other consumer organisations to participate in energy policy making and regulatory activities.

We also submit that there must be ongoing reviews which consider the effectiveness of consumer consultation, including consideration of whether the entire framework promotes the interests of consumers.[8] Such reviews should occur following each round of price resets.

Institutional arrangements

We submit that the energy market institutional arrangements have facilitated a lack of focus on consumer interests and subsequently decisions resulting in over-investments and/or excessive profits by network businesses.

When the institutions were established, it was thought that there should be separation between rule-making and rule implementation or enforcement. This separation is said to result in independent decision-makers with clear accountabilities and objectives. It was also said that this separation reduced the prospect of conflict between the functions. In reality, it appears the conflict has reduced the capacity of the AER to act independently in the public interest—it is constrained by rules set by a different institution.

It is interesting to note that the AER has received the lion's share of criticism about the first set of national distribution price determinations. In particular, a number of State Ministers have sought to reform the AER by advocating for it to be 'structurally separate' from the Australian Competition and Consumer Commission (**ACCC**). This criticism is misplaced. As noted above, the AER was limited by the rules it was to administer, rather than lacking resources or independence. The success of appeals by businesses suggests that the AER did endeavour to limit businesses' revenue, but many of its decisions were wound back due to unfavourable rules.

The Harper Review on Competition Policy has also recommended that the AER be rolled into a new Access and Pricing Regulator, and be separate from the ACCC. The evidence supporting such a change is weak, and there is much consumer benefit from economic regulation working in tandem with consumer and competition regulation.

[8] For further information about good practice consumer consultation, see Consumer Utilities Advocacy Centre (2013), *Meaningful and Genuine Engagement: Perspectives from Consumer Advocates,* available at: http://cuac.org.au/index.php?option=com_docman&task=doc_download&gid=307&Itemid=30.

In consumer protection, the ACCC has taken a keen interest in the energy market—most recently through court action against EnergyAustralia (and their telemarketer, Bright Choice Australia) in relation to poor telemarketing conduct. Its investigation was coordinated with the AER, which has also instituted court action against this business relating to the bypassing of explicit informed consent laws to sign-up customers. Similarly, the ACCC's 'discounts off what' court actions against AGL and Origin (relating to the use of unclear discounts as a marketing tool) support AER goals around effective retail energy markets—clear marketing is essential to build consumer trust in a complex market. This action has recently resulted in a Federal Court finding that AGL misled its customers.

There are significant other benefits in maintaining a coordinated regulator responsible for competition, consumer protection and economic regulation in the energy sector. These functions are inextricably linked and are based on an economic understanding that fair and effective markets are in the long-term interests of consumers. Maintaining the AER-ACCC relationship also ensures skills are shared between these institutions, and that the broad focus of the ACCC contributes to it being less likely that the AER becomes captured by the industry it regulates—a significant risk for industry-specific regulators.

Rather than focusing on the AER, we submit that there is a greater need to consider the structure of the AEMC and whether a separate rule-maker promotes the long-term interests of consumers. As noted above, the AEMC were strong proponents of restricting the AER in its ability to regulate the network businesses through providing detailed prescription in the rules. More recently, the AEMC has released its rule change on network tariff arrangements.[9] Unlike the economic regulation rule change which regulated the total amount of revenue businesses could recover, the network tariff rule change regulates how this revenue is collected from consumers. The main driver of this rule change was to reduce cross-subsidies in the way networks charge: those that create a burden on the system (i.e. those with high air-conditioner use) should pay for that burden. However, it is instructive to note that the AEMC's final decision leaves significant discretion to the network businesses in setting tariffs—while each network tariff must be based on long-run marginal cost, network businesses will have flexibility about how they measure long run marginal cost. While we welcomed the requirement on network businesses to consider the impact on consumers of changes in network prices and develop price structures that are able to be understood by consumers, the level of flexibility will necessarily limit the AER's role in relation to network tariffs.

We consider there may be merit in considering whether it is necessary to have structural separation between the energy market rule-maker and regulator. It seems to us that the public and political pressure to deliver consumer outcomes is placed on the AER as regulator, rather than the AEMC as rule-maker. Should there be one institution that makes and administers the rules, the accountability would be with that body rather than be diluted between two different organisations.

[9] Australian Energy Market Competition (2014). *Rule Determination: National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014*. Accessed at: http://www.aemc.gov.au/getattachment/de5cc69f-e850-48e0-9277-b3db79dd25c8/Final-determination.aspx

The changing role of networks

There is no doubt that the role of our energy networks are changing, driven by new technologies, and higher energy prices. Innovations are occurring in the types of energy products available, but importantly consumers are now engaging in the generation of energy through rooftop solar, and participating in demand side management. These changes are bringing competition to the networks and challenging their business models—rather than a passive, centralised supply system, the networks are increasingly becoming merely a source of back-up power. The availability of local battery storage is likely to challenge their business model further, and may encourage consumers to disconnect from the electricity grid entirely.

These changes will also challenge the regulatory framework, and have a number of social and political consequences. The first is likely to be the result of efforts to reduce cross-subsidies in network pricing, as proposed by the AEMC network pricing rule change. While this rule change should mean those who create a burden on the network pay for that burden, it is likely to affect many consumers who have already invested in ways to reduce their use of the system (i.e. by installing rooftop solar, or making their households more efficient). These consumers may have reduced their total burden on the system (in terms of kilowatt hours), but still be significant users at peak use periods, where the costs of the network are the highest. Further, the network pricing rule change may enable network businesses to increase the proportion of their charges that are fixed, limiting the ability of efficiency activities to reduce overall bills. When consumers who have invested heavily in efficiency or alternative generation understand that their network costs will not decrease, there is likely to be consumer backlash—many will feel that they have been misled.

The second issue arises from the fact that different consumers will be able to participate in the new energy markets in different ways. While new technologies and the ability to better manage power use undoubtedly benefit savvy consumers, there is a significant risk that those consumers who are unable to afford or manage these innovations (i.e. they can't afford the capital costs, are restricted in when they use power, or have literacy or language barriers) will bear the burden of the changes. It is those consumers left on the grid—perhaps the more vulnerable and low-income groups—that will be footing the bill of the network.

We submit that one of the best ways to deal with falling electricity use and utilisation of the energy network is to write down redundant assets. This will mean that those more excluded groups that have limited capacity to be active participants in managing energy use are not unduly burdened by continuing to bear the costs of sustaining the full network. This has been recommended by the Grattan Institute, among others.[10] One way of doing this would be to reconsider the rule change proposed by the Major Energy Users from 2012 which proposed greater power for the regulator to limit the assets included in the regulatory asset base upon which businesses generate returns.[11] There may be others ways of achieving this outcome.

Alternative regulatory models

A number of advocates have proposed radical changes to the regulatory frameworks to reduce the prescription and technicality of network revenue determinations. These include more

[10] Grattan Institute (2013). *Shock to the System: dealing with falling energy demand.* Accessed at: http://grattan.edu.au/wp-content/uploads/2014/03/804-shock-to-the-system.pdf.
[11] Major Energy Users (2012). *Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets,* available at: http://www.aemc.gov.au/Rule-Changes/Optimisation-of-Regulatory-Asset-Base-and-Use-%281%29.

deliberative approaches such 'negotiated settlements' being used to obtain agreement between businesses and consumers, with a more limited role of the regulator.[12] We do not have a fixed view about the benefits of such frameworks, other than to note that to be successful they will require a much more effectively resourced consumer sector—perhaps the resources of the regulator will have to move to the consumer sector. That said, we submit that there be ongoing evaluation about these models in other jurisdictions which might lead to a review of this model for Australia.

Yours sincerely
CONSUMER ACTION LAW CENTRE

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[12] Bruce Mountain (2013). *A summary of evidence and thinking on negotiated settlements in the regulation of energy network service providers*. Accessed at: http://cmeaustralia.com.au/wp-content/uploads/2013/09/Mountain-2013-evidence-and-thinking-on-negotiated-settlements-.pdf