Independent Pricing and Regulatory Tribunal

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24 October 2012

The Standing Committee on Energy and Resources
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Dear Ministers,

We welcome the opportunity to provide comment to SCER on policies affecting network pricing, particularly changes to the Limited Merits Review (LMR) regime.

We commend SCER for appointing the expert panel to review the LMR regime. Changing the LMR regime is an important measure that SCER can implement to address policy settings that are leading to higher than necessary electricity prices.

Our submission illustrates the impact of network price increases on regulated retail prices in NSW and recommends changes to policy and regulatory settings relating to electricity networks, particularly the LMR regime.

If you have any questions, please contact Anna Brakey on 02 9290 8438 or Alexus van der Weyden on 02 9290 8460.

Yours sincerely

Peter J. Boxall, AO
Chairman

IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Promoting the long term interests of electricity customers

IPART's submission SCER on network policies and regulation

Electricity
October 2012

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1 Overview

IPART is the economic regulator of electricity and gas retail prices for small customers in NSW that have not entered into a market contract with a licenced retailer. We are well placed to comment on electricity policies, the implications they have for the cost of providing electricity to end-use customers and the impact that rising electricity prices have on households and small businesses in NSW.

Electricity prices in NSW have doubled (including inflation) over the past 5 years in NSW. Network price increases in NSW have been the largest contributor to price increases, which have been exacerbated by successful appeals by the NSW network businesses under the Limited Merits Review (LMR) regime. In response to increased electricity prices, governments have focussed attention on addressing inappropriate policy and regulatory settings. Addressing these issues will improve productivity within the electricity sector and in the broader economy. It will be in the long term interest of customers.

In this context, our submission:

- Comments on drivers of price increases for small customers in NSW over the past 5 years.
- Recommends measures to improve productivity by limiting future network cost increases, including:
  - changing the current LMR regime
  - the economic regulation provisions within the National Electricity Rules (currently under review)
  - setting reliability standards efficiently and with regard to the willingness of the community to pay for specified standards (currently under review)
  - the appropriate deployment of time-of-use or smart meters.

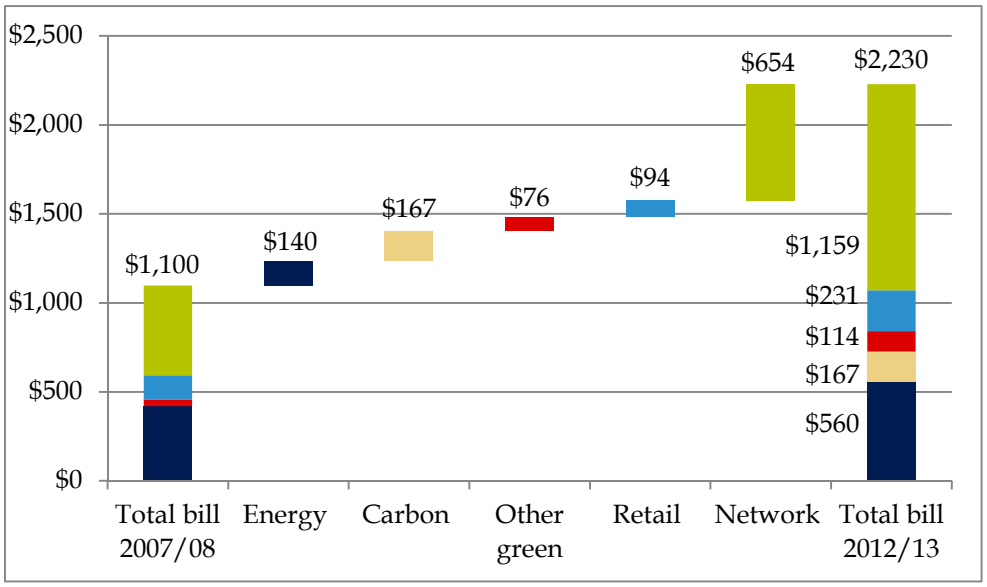
2 Drivers of NSW electricity prices over the past 5 years

Over the past 5 years regulated retail electricity prices in NSW have more than doubled in nominal terms. In real terms, they have increased by around 79%.

Network charges are the main driver of the price increases. As demonstrated in Figure 2.1, network prices comprise around half the total retail bill. Over the past 5 years they have increased by 130% in nominal terms (or 102% in real terms), adding around $654 to a typical retail electricity bill.

The next largest contributor to increases in regulated electricity prices has been the cost impact of introducing or amending green schemes – adding $243 to bills.

Figure 2.1 Change in average regulated NSW residential customer bills, 2007/08 to 2012/13 ($nominal)



Note: Contributions made towards the NSW Climate Change Fund are included in network costs rather than green costs. The energy, carbon and green costs include losses. Typical bills calculated assuming consumption of 7MWh per year.

In response to the level of these electricity price increases, governments have focussed attention on addressing inappropriate policy and regulatory settings.

3 Recommendations to address inappropriate network policy and regulatory settings

We consider that recent network cost increases, which are responsible for most of the recent retail price increases, may be higher than necessary due to aspects of the regulatory framework which are contributing to inefficient outcomes. The cumulative effect of the economic regulatory provisions of the NER is rapidly increasing network prices, which flow through to retail prices and customer bills.

The most important policies relating to network pricing are currently under review. We encourage SCER to adopt its expert panel's recommendations on changing the LMR regime. Also, we encourage the AEMC to make changes to the economic regulation provisions within the NER and for governments to consider the specification and level of network reliability standards nationally and specifically in NSW.

3.1 The merits review process should be changed in the National Electricity Law

Recommendation

1 The SCER should adopt in full the expert panel's recommendations to change the LMR regime, but the appeal body should not hear evidence that was not before the first-instance regulator.

To date, the businesses have sought merits review of elements of every decision the AER has made on their regulated returns. In NSW, the distribution network businesses sought review of the averaging period for the risk free rate of return in their WACC calculation, which resulted in an additional $1.9 billion in allowed revenue over 5 years (out of a total of $18 billion).[1]

SCER engaged an expert panel to review the LMR regime. The expert panel made a range of recommended changes, including to focus the review on making a preferable decision that is consistent with the National Electricity Law (NEL) and National Gas Law (NGL) objectives in ways that best serve the long term interests of customers, to move away from an adversarial review to an investigative review and to have appeals heard by an independent administrative body.

We broadly support these recommendations of the expert panel's report to SCER. However, we are not convinced that the appeal body should hear evidence that was not before the first-instance decision maker due to the time, cost and gaming opportunities that it presents.

The following section summarises key points that we made to the expert panel in its review process.

A decision should only be replaced when it better serves the National Electricity Objective

The current merits review process, involving the Australian Competition Tribunal reconsidering the merits of the AER's decision, has the benefit of focusing on the issues in dispute. However, the Australian Competition Tribunal does not consider the merits of individual component decisions in the context of the AER's whole determination, or the effect that modifying these decisions may have on electricity prices and in meeting the National Electricity Objectives - the long term interest of consumers. Therefore, it cannot consider, for example, whether the businesses will still face appropriate incentives regarding infrastructure investment from other aspects of the AER's decision. The appeal process should ensure that a substitute decision is made only when it better meets the National Electricity Objective, compared to the AER's decision.

1 Australian Competition Tribunal, Application on EnergyAustralia and Others (includes corrigendum dates 1 December 2009)(2009) ACompT (12 November 2009).

Providing a single ground for review (that a materially preferable decision exists) will require the appeal body to balance its decisions and will therefore limit the 'cherry-picking' concerns with the current regime.

Our view is consistent with the expert panel's view.

The review body should be an administrative body

The review process should apply a less court-like approach to hearing an appeal to allow the review body to 'stand in the shoes' of the first-instance regulator. In our view, a court-like body such as the Australian Competition Tribunal is not necessarily experienced in broader stakeholder management or the exercise of regulatory discretion. Regulators necessarily exercise discretion in making price determinations. Informed discretion is required in making both constituent decisions and in making the overall revenue requirement decision. A merits review body should be able to undertake the same balancing process as the regulator.

Many of the network appeals to date have focussed on the cost of capital. Correcting the 'errors' within these calculations does not necessarily improve the overall decision making (the overall determination of a revenue requirement) given the complex interactions between the variables. Many of the 'errors' are in fact differences of opinion on highly complex and contentious topics (for example, the value of 'gamma'). They require the use of discretion. In exercising its judgment the ACT may view the relationship between variables in a different way to the regulator, including how each variable relates to an appropriate revenue requirement that is in the long term interest of customers.

However, currently the ACT is doing so without the benefit of hearing directly from all stakeholders who participated in the regulatory process, including community representatives. Instead, the ACT hears primarily from the stakeholder seeking review of the regulator's decision and possibly from the regulator, unless other stakeholders have sufficient financial backing and standing to intervene.

We recommend the establishment of an appeal body that is capable of standing in the shoes of the regulator, undertaking the balancing of competing interests and exercising discretion and judgement in the context of the overall objective of the long term interests of customers. The expert panel has suggested that a new administrative body be established. We support the expert panel's recommendation.

The review body should consider the information before the first-instance regulator

We recommend that the appeal should be a 'desk top' review, relying on the information available to the first-instance regulator. No new or further information should be able to be introduced by the parties.

While the expert panel recommended that the appeal body consider the evidence before the first-instance regulator, it sees this as a starting point with the appeal body collecting and examining new information on an incremental basis.

A reason cited for hearing new evidence is to limit the incentive for network businesses to provide a large amount of detailed information to the first-instance regulator in a timeframe that makes it difficult for the regulator to adequately consider the information, but makes it admissible for the subsequent appeal. We consider that this incentive to provide information can be managed through a well-designed review process.

Having the appeal body hear new evidence would increase the time and cost involved in the appeal process and might provide incentives for gaming by withholding information as part of the original decision. On balance, we consider that the appeal body should not hear new evidence.

3.2 We support the AEMC's proposed changes to the NER and recommend further strengthening of the provisions for efficient expenditure

Recommendation

2 The AEMC should change the National Electricity Rules :

- to allow the AER to adopt its best estimate of efficient costs
- to allow the AER to set its best estimate of the WACC
- to include only efficient expenditure in the Regulatory Asset Base so that customers do not pay for inefficient capital expenditure
- to improve the incentives for efficient expenditure under the NER for all network operators, and particularly for State-owned corporations.

The AEMC is currently reviewing the economic regulation provisions within the NER. We welcome this review as we consider that the current arrangements are inappropriate and have led to higher than necessary network prices.

IPART has been participating in this review, articulating in detail the problems with the current NER and the improvements that should be made. Specifically, we consider that changes should be made:

- to allow the AER to adopt its best estimate of efficient costs
- to allow the AER to set its best estimate of the WACC
- to include only efficient expenditure in the Regulatory Asset Base so that customers do not pay for inefficient capital expenditure
- to improve the incentives for efficient expenditure under the NER for all network operators, and particularly for State-owned corporations.

In August 2012, the AEMC released its draft decision on required Rules changes and have largely addressed the issues listed above. We generally agree with that draft decision. However, we think that the AEMC should strengthen its position on including only efficient expenditure in the Regulatory Asset base so that customers do not pay for inefficient capital expenditure. We are of the view that the ex-post review should apply to all expenditure (not only expenditure in excess of the ex-ante cap) because:

- there is no systematic reason why changing external circumstances should not also lower capital expenditures
- it is important to provide stronger incentives for network businesses to invest efficiently, particularly where the shareholder and governance framework for network businesses may not provide effective financial incentives
- the AEMC's proposed ex-post review mechanism alters the incentives for the network businesses and the regulator as part of the initial determination of capital expenditure and the incentives for the network businesses during the regulatory period
- the allocation of risk, in terms of who bears the impact of changes in costs resulting from external environment, should be symmetric if the ex-post review is to be consistent with the AEMC's capital expenditure objective; namely that customers only pay for efficient and prudent expenditure.

This is particularly relevant given that we are in an environment of declining electricity demand (relative to the high growth forecasts underpinning the recent determinations). Network businesses need to be provided with strong incentives to review and reassess capital expenditure programs during this period. All else being equal, capital expenditure in the next regulatory period might be lower, and customers should be able to benefit accordingly.

3.3 Network reliability standards

Recommendation

3 Governments should have regard to customers' willingness to pay and conduct a cost-benefit analysis before altering reliability standards.

4 To facilitate the least-cost delivery of a specified standard, distribution network reliability standards should be expressed on a probabilistic basis.

At present, reliability standards are determined by each jurisdiction and are typically set out in the network operators' licence conditions. All else being equal, the higher the standards for reliability and customer service, the higher electricity prices paid by all customers.

The reliability standards set out in the network operators' licence conditions reflect judgements made by Government (on the community's behalf) of the level of service (and the associated cost) valued by the community. In determining these standards governments should consult with electricity consumers - both business and residential customers - to understand the different benefits they enjoy from a more reliable supply of electricity and the extent they would be willing to pay for these benefits through higher energy prices.

The AEMC has recently completed its review of reliability standards in NSW and concluded that reductions in capital expenditure under all 3 of the review's scenarios for lower distribution investment significantly outweighed the costs to customers of slightly lower levels of reliability.[2]

Currently the standards in NSW include requirements on how distribution businesses must plan their networks in addition to specifying the reliability standards (a 'deterministic' approach). The AEMC engaged the Brattle Group to examine the approach to setting electricity distribution reliability standards and outcomes in Australia, New Zealand, Great Britain, Italy, the Netherlands and the US. The Brattle Group found that:

> Whilst the Australian approach to regulating distribution reliability is generally very much in line with other jurisdictions … NSW appears unique in applying input standards that are driving investment decisions[3]

We are concerned that the deterministic approach does not necessarily allow the specified performance of the distribution network at least cost. It is imperative that any regulatory settings encourage the objectives to be achieved at least cost to the community. We therefore recommend that reliability standards be specified on a probabilistic basis and based on customers' willingness to pay.

3.4 Pursuing cost effective opportunities to deploy time-of-use and/or smart meters

Recommendation

5 The roll-out of time-of-use meters should be at the discretion of the customer or their retailer rather than being mandated by governments or distributors.

In recent years, Australia has experienced declining utilisation of its energy infrastructure. This is driven by the growth in peak demand outpacing the growth in underlying energy consumption. Expenditure is being incurred to provide additional generation and network capacity, with this capacity being used for only a fraction of the time. This additional expenditure is reflected in generation and network prices, and ultimately in electricity bills for customers.

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2 AEMC, *Review of distribution reliability outcomes and standards, NSW workstream*, 31 August 2012.

3 The Brattle Group, *Approach to setting electricity distribution reliability standards and Outcomes*, January 2012, p 13.

Policies surrounding the deployment of time-of-use meters have been determined by State governments or the distribution businesses themselves in some circumstances.

There are opportunities for improved utilisation of energy infrastucture including minimising peak demand through **cost effective** deployment of time-of-use and/or smart meters.

We support the take-up of time-of-use and/or smart meters through a competitive market and at the discretion of the customer or their retailer. Customer initiated uptake of time-of-use meters (with the customer potentially paying for the installation of the meter) could target those customers with the greatest willingness or ability to shift their demand. It is likely that individual customers will be in a better position to gauge their ability to respond to price signals than government. Retailers may also be in a position to manage the demand of their overall customer base through programs targeted at individual customers or groups of customers.

Importantly, improving the productivity of the electricity sector requires the benefits from deploying time-of-use and/or smart meters to exceed the costs.