

Energy Action Group

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Energy Action Group Submission to the Productivity Commission on “Access Arrangements”

The Energy Action Group is Incorporated in Victoria as a “not for profit” Association. The organisation has represented the interests of residential energy consumers over the past 20 year in both state and federal spheres. The Energy Action Group was excluded from any opportunity to participate in the round table process in Sydney due to the lack of space.

The Energy Action Group has participated in a plethora of inquiries, hearings and determinations over the past 5 years for both the electricity and gas industries. The organisation has an intimate knowledge of the National and State based regulatory environment and the impact that regulated price determinations have on consumers.

Given more resources and time the EAG would have made a significantly larger contribution to this Inquiry. EAG is cognisant that the majority of submissions to this Productivity Commission Inquiry will be made by organisations and companies that make their incomes from either owning infrastructure assets that are regulated or providing advice to these companies. One of the particular features in the Australian regulatory environment is the small number of submissions that come from consumers and the demand side.

In almost all spheres of the reform process, the various jurisdictions and regulatory bodies have failed to adequately consult with the underwriters, consumers. It is EAG’s contention that this Productivity Commission Inquiry should also address the issue of customer access to the various processes and their contribution to the development of the various markets. There is a significant need to examine the risks associated with market design and the costs and benefits of market access for the various classes of consumers.

One example is the implementation of Full Retail Competition and the barriers to entry of new entrants and the high cost of the proposed Information Technology needed to settle the NEM or the Victorian gas market. The failure by the jurisdiction to examine the risk and the costs of and benefits of using Net System Load Profiling as the technique to settle the 2 markets is of serious concern. The market related risk are increased by the ACCC Final Determination of a \$A 10,000 price cap on Value of loss of Load to take effect from April 2002 will further add to the risk premium be paid for by consumers.

There are no effective mechanisms or resources in place for market participants and consumers to examine the current the NEM and the Victorian gas market designs and proposed market settlements arrangements, until the ACCC NEM market review in 3 years. The NEM uses a gross pool, ex post pricing which adds significant risk to the retailers, who in turn, respond by building a significant risk premium into their offerings to consumers.

Another area to examine and investigate is the costs and the effects of self interest that some of the jurisdictions have shown in the infrastructure reform process to date. This observation particularly applies to jurisdictions that own and regulate assets. One obvious example is demonstrated by the NSW asset value variation in the electricity industry over the past 3 years. This variation raise some interesting questions around jurisdictional self interest (particularly that of Treasury) and whether the outcome serves the consumers best interests.

There are significant problems associated with the regulatory approval process that need exploration. It seems that if a particular access or market application complies with the relevant Code, then ACCC for instance, would have to approve the application. This point is more than demonstrated by the ACCC Authorisation of the Victorian gas Market System Operating Rules (MSOR).

Australia appears to be quite unique internationally. This is the only jurisdiction that the EAG is aware of, where, the few informed consumer groups regularly consult with each other. In fact, 95+ % of the

issues in the regulatory and market environment is common between big and small user groups. The Victorian gas market provides an even more unique example. In this case, the industry and informed consumers believe that the market is unworkable in its current form. The only supporters of the Victorian gas market are the jurisdiction, the jurisdictionally owned Independent System Operator VENCORP (No Liability) and the consultants who designed the market, yet ACCC approved the MSOR.

Resourcing

The most important standout issue for the EAG is the failure by the jurisdictions to adequately resource the demand side. The small number of demand side submissions to this Inquiry will strongly reflect this point. The vast majority of submissions will come from the supply side or industries/ professions that receive the majority of their revenue from the supply side. The bulk of submissions will reflect a strategy to increase the costs to consumers via increased revenue for regulated entities.

The nature of this problem has been amply demonstrated in process, submissions and outcomes of the recent Victorian Office of the Regulator General Pricing Determination 2001- 2005. The Victorian Office of the Regulator General Final Pricing Determination for instance, awarded the 5 Victorian distribution businesses a sum of \$ 67 m to participate in regulatory proceedings from 2001 to 2005.

Not only are consumers expected to pay for the infrastructure but in the majority of cases they also pay the owners and the businesses so that they can participate. Even a cursory analysis of the submissions to any jurisdictional pricing inquiry or ACCC access arrangements will conclusively demonstrate the asymmetry in resourcing between consumers and the regulated industries and their advisors. The failure by the jurisdictions and market participants to ensure that consumers are adequately resourced has added between \$500 - 1 b/annum to the prices that consumers pay for goods and service from regulated entities.

Additional Unnecessary Cost Burdens

The following simple examples make this point. An analysis of the ORG Victorian Pricing Electricity Pricing Inquiry 2001-2005 indicates that the effective resourcing of the demand side, coupled with full and open participation would have saved consumers over \$ 250 m over the 5 year regulatory period. Currently it appears that the industry and NEMMCO implementation of Full Retail Contestability in the electricity market looks like costing between \$ 1.5 b to \$ 4 b over a 5 year period without one customer switching retailer. There are major Information Technology and metering costs that are associated with the implementation of FRC before customers can transfer between retailers without imposing costs on other consumers.

Currently only one consumer, representing the Australian Consumers Association has any direct involvement in the electricity FRC decision-making process, at best this can be described as minimal customer involvement. The electricity FRC process ultimately will involve 7 million consumers who will have to bear the costs and risks of implementation. The jurisdictions and the ACCC have failed to address the issue the costs and benefits of FRC and what direction of the market needs to take to minimize customer risk and maximise the benefits. The NSW Treasury MIG implementation of the Electricity Tariff Equalisation Fund is practical example of minimizing competition and transferring risk on to NSW taxpayers, customers and retailers.

There are significant risk costs associated with the design of the NEM which is a gross pool, ex post market, coupled with the failure by ACCC and the jurisdictions to effectively implement a competitive contestable market for electricity looks like costing load profiled consumers between \$ 10 and \$25 /MWh on EAG's current assessment.

Some Asset Valuation Methodology Issues

The use of Rate of Return or Price Cap regulation provides both private sector regulated bodies and jurisdictionally owned entities with several mechanisms to maximise revenue at the expense of consumers. The first is to use asset maximizing accounting methods like Optimised Deprival Value (ODV), Depreciated Optimised Replacement Cost (DORC) or some variant asset valuation

methodology. One of the finest exponents in the nation of manipulating asset valuations is NSW Treasury, exemplified in its submissions to Independent Pricing And Regulatory Tribunal (IPART), Special Reference on Electricity Pricing. AGL gas has also been a substantial bonus as a result of NSW Treasury's endeavors. Some more blatant examples of asset manipulation have been included in other submissions to the Inquiry.

A further variant of the asset value maximising technique is to slow down the rate of depreciation in regulatory pricing applications. The process of slowing the depreciation cycle so that failure occurs before the item is fully depreciated has the effect of maximizing the size of the asset base.

The manipulation of depreciation and the depreciation cycle by the regulated businesses will determine the quality of service received by consumers and the rate of penetration of new innovative technology. This point is yet to be effectively addressed by the nations regulators in any pricing determination delivered so far.

The Victorian distribution company Powercor for instance, in its December 1st submission of the Office of the Regulator General changed its depreciation cycle on wooden poles in its distribution system from 5% to 0.5%, by the use of pole staking and preservative injections to the base of the poles. This was a practice inherited from the SECV. This technique does not address the problems associated with stem rot and the poles breaking off half way up the pole. The replacement pole is a new capital item.

The next area of concern is the use of **real interest rates** via the use of Weighted Cost of Capital (WACC). The regulatory concept is to try and determine a market rate of return. EAG is of the opinion that regulated entities are subject to minimal business risk other than bypass or retailer failure. Therefore the use of sophisticated beta's and other devices to argue an increase in WACC is unreasonable. **The closest market indicator interest rate for regulated businesses is the Government bond rate with a risk premium added.**

It is worth noting that the use of real asset and WACC's in regulatory determinations makes the businesses bullet proof against inflation. EAG recognizes that the use of real figures enables a sound comparison to be made between a number regulatory periods. However the regulatory treatment of accounts give the businesses an inflation proof asset and rate of return. The regulated businesses are further helped with a guaranteed revenue streams. **EAG wishes to point out that no other businesses in the country receive the same benefits as those given to regulated businesses in pricing and revenue determinations.** This point seems to be overlooked in the WACC determination process by the Australian regulators. The current regulatory direction is to add complications to the determination of WACC that substantially benefit regulated entities. The regulators should be trying to simplify the WACC determination process rather than providing a financial feast for consultants.

One of the most significant regulatory failures to date is the failure by jurisdictions and regulators to set up an adequate set of accounting standards for regulated entities. This is particularly evident in the area of Operations and Maintenance expenditure. The huge disparity in the 5 Victorian distribution business submissions to the ORG Electricity Pricing Inquiry 2001- 2005 raise some serious questions as to whether or not the lack of accounting standards has enabled the regulated businesses to game the light hand regulatory system. This problem is then further compounded by the use of a primitive benchmark performance system as the reward incentive process.

This is particularly evident in the electricity industry bench -marks which are in the main smeared averages there are a number of excellent examples particularly from the ORG 2001-2005 Pricing Determination. One rather useful example of a useless performance indicator come from the Victorian Royal Commission on the Metropolitan Ambulance Service¹. **Rewarding regulated business using useless performance indicators, doesn't protect consumers, it only rewards poor performance.**

¹ The AGE, Tuesday, December 19th p.2. Indicated the problems of inappropriate bench- mark targets for Intergraph in the most recent disclosures in the Victorian Royal Commission into the Metropolitan Ambulance Service. Where the Performance Indicators were called "at best unreliable or at worst undecipherable". In the example, if a call was not answered after 6 rings it was returned to Telstra where it was forwarded to another Intergraph emergency number. If the call was not answered for another six rings it was forwarded again to Telstra, to be forwarded to the next Intergraph emergency

The Victorian Pricing Determination Appeals Panel further exacerbated the benchmark issue in their application of the reward for good or innovative performance X (efficiency) Factor. Their finding rewarded load growth over and above the 1995, 5 year forecast as increasing efficiency. Business that have growth rates above the 5 year forecast are generally rewarded by being granted an increase in capital investment and augmentation expenditure (Capex) into the regulated asset base for the next and future regulatory cycles.

The failure to develop adequate bench -marks and accounting standards has enabled some regulated entities to game the regulatory process to date.

Conclusion

The Energy Action Group is of the belief that there are significant systemic problems that are not being addressed in the reform process, this submission has made brief reference to the most significant issues of concern. The jurisdictions have not looked after consumer interest contrary to their rhetoric on this matter.

EAG suggests that the Productivity Commission examine the risk and costs imposed on the various regulated participants in the reform process that are then passed on to consumers as cost increases.

Many of the businesses involved in the reform process appear to be suffering from reform fatigue, an issue reflected by the small number of participants involved in the electricity industry Full Retail Competition process.

number. The six ring benchmark started every time Telstra forwarded the call. So the length of time a caller was kept waiting was never recorded and Intergraph was rewarded for meeting its benchmark.