

Ian Tunstall Solicitor
ABN 76 207 879 522
16 Orient Street
PO Box 91 Lawson NSW 2783
Australia

Tel (02) 4759 2641
Fax (02) 4759 3013
Mob 0414 481 555
Email tunstall@pnc.com.au
Web www.iantunstall.com



REF: 2012-PC01

22 November 2012

Electricity Network Regulation
Productivity Commission
GPO Box 1428
CANBERRA CITY ACT 26001

Dear Sir

SUBMISSION TO PRODUCTIVITY COMMISSION DRAFT REPORT ON ELECTRICITY NETWORK REGULATORY FRAMEWORK

I submit that the Draft Report on Electricity Network Regulatory Framework, October 2012, shows that the Productivity Commission's Inquiry runs the risk that the real problems for the National Electricity Market may be overlooked as regulatory processes are examined to discover the reasons for rising electricity prices.

I have watched and studied the Electricity sector since 1998 as solicitor for the New South Wales Energy and Water Ombudsman and later since 2006 in publishing a newsletter, *Australian Energy Law and Economics*. I have observed the development of the regulatory framework for electricity and the work of the Australian Energy Market Commission to amend the National Electricity Rules.

My concern about the Productivity Commission's Inquiry is that the Terms of Reference may appear to be drawing in of the Commission to a political dispute between the Commonwealth Government and the State Governments owning electricity assets. Also, the Inquiry runs the risk of being bogged down in aspects of the National Electricity Rules that are too prescriptive causing the Australian Energy Regulator to intervene in the management of businesses operating in the National Electricity Market. The Regulator attempts to replicate the actions of a free market and clearly upsets many market participants. Also, government ownership inhibits the market and together with interventionist policies, contributes to rising prices for electricity to businesses and consumers.

This submission highlights my concerns about the Inquiry and points to the need for a proper economic analysis of the electricity sector to recommend significant change to its structure, operation and regulatory framework.

Yours faithfully

Ian Tunstall
Solicitor

Liability limited by a scheme approved under Professional Standards Legislation

Liability limited by the Solicitor's Scheme, approved under the Professional Standards Act 1994 (NSW).

Approach to the Inquiry

The illustration of the car with no engine having a punctured tyre is an interesting approach to the Productivity Commission's Draft Report: Electricity Network Regulation Frameworks, October 2012:

"There is, in effect, no point in simply fixing a punctured tyre if the car has no engine."

This approach to the inquiry, it is hoped, will discover the problems identified by the Treasurer in the Terms of Reference for "the efficient delivery of network services and electricity infrastructure to meet the long term interests of consumers". The reference to the National Electricity Objective (NEO) is a problem as that objective is itself a cause of the lack of attention given to consumers in the delivery of electricity and related services and infrastructure.

In the context of the electricity market the concept of a car with no engine could be due to the fact that the car is a battery powered vehicle, having no internal combustion engine. Looking at the issues of network service providers only, the Inquiry may miss the broader issues involved in the supply of electricity and the infrastructure used to deliver services to customers. The underlying issue is the regulatory framework in which network service providers, generators and retailers are required to operate their businesses. The risk posed by the Terms of Reference can be seen as political rather than economic (examination of the regulatory framework). The Prime Minister's speech, "Electricity prices: the facts", given to the Energy Institute of Australia, Sydney, 7 August 2012, says:

"Large scale electricity infrastructure established in the post-war period is reaching the end of its useful life and that is a very substantial component of the network."

While the Inquiry has adopted a broader perspective to reflect the "complex interactions between multiple influences", there is the risk that submitters will concentrate on the minutiae of the operation of network businesses under the National Electricity Law and Rules. This could call into question the scope of the Inquiry to deal with the regulatory requirements for items such as benchmarking, incentive regulation (an oxymoron) and other regulatory activities, and ignore the larger economic questions as stated in the Terms of Reference, "the effectiveness of the application by network businesses of the current regulatory regime for the evaluation and development of interregional network capacity in the National Electricity Market (NEM)."

The risk can be seen in the substance of submissions made to the Productivity Commission's Issues Paper. The submission from the Australian Energy Regulator is typical in explaining the regulatory issues it administers under the National Electricity Rules. This work would not be necessary if a free market operated. The question is: why attempt to replicate the free market in the activities carried out by the Australian Energy Regulator?

A better approach is to measure the current regulatory framework and its particular controls such as benchmarking against a broader economic scope of a free market for electricity supply. This would raise issues of ownership, government intervention, and the impact of the National Electricity Law and Rules on the effective operation of all electricity market participants. Also, it would raise the issue of ageing assets as stated in the Prime Minister's speech. Potential problems of the misuse of market power can be dealt with by the Australian Competition and Consumer Commission for monopoly enterprises operating in the National Electricity Market.

Risk of political bias in the Inquiry

The Inquiry could be seen as an extension of the political debate about “gold plated” electricity infrastructure. To avoid such a claim, the Inquiry needs to examine the economic issues of the National Electricity Market and the regulatory framework giving rise to the issues of benchmarking and interconnector activities.

The Prime Minister’s speech also notes:

“At the heart of all this is a simple market design problem: a clear regulatory incentive to overinvest in infrastructure and pass on costs to consumers.

Indeed, in many places around Australia, the State Governments both own lucrative electricity assets and regulate parts of the electricity market.

The comparison between the private and public owned utilities shows the States are doing very well financially out of this arrangement.”

According to the Prime Minister’s speech, the then recent round of price increases the revenue for State owned network enterprises “is up fifty percent over the previous five year period.” Private network enterprises had an increase of thirty percent over the same period.

The political connection to these observations is the allegation of “gold plated” electricity infrastructure that arose out of the Council of Australian Governments meeting on 25 July 2012. In this context, the Prime Minister’s speech accuses some States are doing well from the financial arrangement with revenues growing faster than in the private sector.

Government owned network service providers

The comment in the Draft Report under State-owned enterprises that “governments have a legitimate role in owning and operating many services in Australia, the rationale for state-ownership of electricity network businesses no longer holds” is a right approach to the Inquiry. Government ownership of any business enterprise in Australia holds no rationale in an economy where many economic agents are available within an international financial markets environment where capital can be raised by risk takers. Government investment in risky businesses is redundant in this environment.

Concentrating on network businesses, the Inquiry needs to discover the extent to which government owned enterprises distort the market for electricity with the provision of government guarantees and allocations from government budgets for the capitalisation of electricity assets. Apart from the economic issues, government owned enterprises earn the accusation of “gold plated” assets that are unrelated to efficient investment in a free market. Consumers of electricity in these States incur increasing prices and higher taxes for their electricity sector. This is not an efficient approach to the generation and supply of electricity to consumers.

Governments do not need to own business assets in order to regulate them. Businesses in the electricity sector are no different from other businesses in the Australian economy. There will be adverse consequences of any privatisation of government owned enterprises as experienced by the ultimate sale of Qantas, Telstra and irrigation assets. The legacy of political and bureaucratic

interference persists as the new entities restructure in view of international and domestic market activities. Once these formerly government owned enterprises are fully commercial the benefits flow to consumers in competitive market prices. A similar situation will occur with the sale of electricity assets as issues of safety and security of supply (the usual political arguments) persist under a privately owned electricity sector.

The issues raised for investigation in the Inquiry about government owned electricity enterprises will involve medium to long term resolution. To start, the ideological debate against privatising electricity assets as shown in New South Wales and Queensland need immediate resolution. The relevant States need to be encouraged and assisted within Australia's federally constituted governing framework to sell electricity assets for the benefit of the National Electricity Market and for the whole of the Australian economy. There may even be threats in the future after privatisation to reregulate these enterprises as was seen with Qantas in 2010.

National Electricity Objective

The National Electricity Objective in the National Electricity Law is expressed upside down. It promotes "efficient investment in, and efficient operation and use of, electricity services" for the "long term interests of consumers of electricity" for "price, quality, safety, reliability and security of supply of electricity" and "the reliability, safety and security of the national electricity system". Consequently, government owned enterprises and others subject to the rules of operation under the National Electricity Rules concentrate on the mechanical or engineering aspects of the objective. They aim for quality, reliability and security of supply and safety at a price that is based on cost plus rationalisation. There is no pressure to reduce costs and operate their businesses on a marginal costing basis to supply electricity at competitive prices. The fact that network service providers are monopolies adds to the approach described.

The better approach is for the National Electricity Objective to state that for the interests of consumers of electricity into the long term, efficient investment is promoted by market participants to supply electricity at competitive prices in the market subject to any intervention and interference by government policies and laws to inhibit the objective of competitive prices. This expression recognises the limitations of the National Electricity Market and the constraints on market participants to invest in electricity infrastructure and services for the supply electricity at competitive prices.

The focus of the National Electricity Objective wrongly places the encouragement of investment of resources into the engineering of the electricity sector rather than focus on the consumer as the real reason for supplying electricity. This approach impacts on the pricing of electricity in the National Electricity Market that should be recognised by the Productivity Commission's Inquiry.

National Electricity Rules

The National Electricity Rules constitute over-regulation that is too prescriptive for the National Electricity Market. This causes the Australian Energy Regulator to operate on a too-interventionist level with market participants. The problem is not confined to network service providers. All energy market participants are affected by this over-regulation.

The over-regulation and prescription of the Rules can be seen in the many occasions the Australian Energy Market Commission is required to examine processes, practices and procedures under the National Electricity Rules to amend them to accommodate changing circumstances or where the practice is redundant. The work of the Australian Energy market Commission is commended but the consultative processes cause the rule amendments to take a long time. This is not an efficient process to provide for proper commercial activities that would change as a matter of course under a free market.

The highly prescriptive nature of the National Electricity Rules causes resources to be directed to unproductive activities and ultimately increases the prices charged to consumers. The Inquiry needs to investigate this feature of the Rules for its impact on the pricing mechanism.

Problems for network service providers

The problems of the network service providers are the regulatory framework and government ownership. These problems contribute to higher costs for the National Electricity Market and higher prices for consumers than is the case for privately owned network providers.

If the Prime Minister's speech is correct about "a simple market design problem" then the direction of the inquiry needs to focus on the regulatory issues and the broader economic analysis of government ownership. But the concept of a simple design problem misses the nature of Australia's energy markets. They are complex as identified in the Productivity Commission's Draft Report. They are also overregulated stemming from the past development of electricity as an essential service and structured as government utilities. This concept of electricity markets still permeates attitudes about electricity supply by governments and consumers. These attitudes have been moulding into an ideological debate about ownership of electricity assets.

The complexity of electricity markets can be seen in the Draft Report that is drawn into the regulatory framework detail by examining the regulatory requirements for transmission and distribution network service providers. The Draft Report is drawn into the jargon and acronyms used by the regulators based on the terms used in the National Electricity Rules. The complexity of the National Electricity Rules is due to the underlying drafting that reflects an "engineering" manual rather than cause regulatory provisions to reflect a broader framework. This approach results in overly prescribed law with heavy regulatory intervention to in effect micromanage participants in electricity markets. Network service providers need to expend resources to respond to the regulatory prescription on business matters that businesses outside the electricity sector do not have to deal with. In addition, network service providers are required to comply with other commercial and business laws as required including the *Corporations Act 2000* and regulations including accounting standards.

Free market and profits for electricity providers

The free market is the most efficient mechanism currently known to lower prices to consumers by disciplining suppliers. Where market failures can really be detected and proven, framework legislation might be introduced. In the case of network service providers and generators the *Competition and Consumer Act 2010* operates to provide a framework for business behaviour and conduct in the market. There is no need to double up regulation as is the case for the National

Electricity Market. Once a regulatory framework is established, procedural rules might be put in place for particular industries as is the case with supervision by the Australian Competition and Consumer Commission and the Australian Securities and Investments Commission under the *Corporations Act 2000*. There are many other laws that regulate business and trade and these should be sufficient in applying to network service providers as all other business enterprises.

It is clear that the Australian economy is not a free market. There are many laws and government policies that interfere in markets causing the economy to be less free. Consequently, free markets are not achievable for electricity but they should not be so encumbered with detailed regulatory prescriptions. Also, there should not be doubling of regulatory prescription as for consumer law. This only impedes the delivery of proper services to consumers and increases costs and hence prices in the market. These regulatory imposts need to be examined to identify excessive regulation that has no proper regulatory effect. All legislation needs to be reviewed regularly to identify inconsistencies and to ensure the purpose of the regulation is achieved. The Australian economy needs to purge itself of regulation and rules that inhibit development and growth.

To encourage new technologies and investment in electricity markets it is necessary to promote sound laws that allow this to occur. Markets are made up of individuals and individuals need encouragement or not be discouraged from taking risks and make investments and develop new technologies. This is the case for electricity markets in Australia. The Clean Energy Future program by the Commonwealth Government supported by the *Clean Energy Act 2011* needs to be handled carefully to avoid unnecessary consequences as the Australian economy transitions to the new regulatory environment. The submission by the Independent Pricing and Regulatory Tribunal New South Wales to the Climate Change Authority's Discussion Paper, *Renewable Energy Target Review*, October 2012, makes the point that the renewable energy target (RET) "is not complementary to the carbon price". The submission says about RET:

"it does not cost effectively address any other significant market failures, it creates market distortions and it has the potential to interfere with the efficient operation of the carbon price and ETS. The COAG has made a commitment to remove schemes that are not complementary to the carbon price, to avoid electricity customers incurring unnecessary costs. We encourage the Authority to reconsider its position."

This is a major problem for electricity markets. The "gold plating" of schemes that may have had some validity in the past but they are now redundant. There are many other schemes affecting the supply of electricity. The Inquiry needs to identify these schemes as affecting electricity markets and more particularly network service providers. Cleaning out these policies and laws needs to be done urgently to allow network service providers and others to structure their businesses to remove impediments.

The optimum solution is not more regulation or changing regulatory imposts. The solution is to aim for a free market. With this in sight, market participants can seek to provide optimum services to meet the demands of consumers and consumers will pay for the services they want at a price that meets their household budgets. Consumers can use free and competitive prices to learn about the market for electricity and to take electricity services as they choose. A free market would cause the electricity sector to become less complex as unnecessary processes and practices are removed. Governments can assist this process by publishing information that is useful to consumers. This

information can be drawn from databases held by governments containing confidential information that can be grouped and recast as more general information for public use. The publications of the Australian Bureau of Statistics can be a guide.

The notion of a free market should not be feared as some would suggest. Also, the notion of business making profits should not be detested. The Australian public who hold these views need support to see that a free market where participants make profits benefits the economy and consumers with lower prices and a better living environment. An economy with free markets will ensure the "protection" of the environment and natural resources to preserve them into the future for further growth. There will always be individuals and groups that will seek short term personal gain by abusing resources and the environment. These individuals need to be dealt with on a case by case basis rather than new laws being introduced to deal with the mischief and punishing everyone for their activities. By socialising punishment to deal with the few individuals is a gross cost to the economy. The exception is perhaps criminal law that sets precepts for educating the public about unacceptable behaviour and conduct.

Free markets allow for individuals and groups to exercise responsibility. This is necessary in the electricity sector for network service providers and other participants to be responsible for their actions to deliver electricity services to customers. By overregulating them the notion of self-responsibility is dampened and improper consequences occur. Organisations such as ombudsman and other consumer organisations are called upon to deal with these improper consequences. This approach does not solve the circumstances arising again. But the regulatory framework could be elevated to assist in resolving these problems by electricity participants exercising responsibility in markets to allow market participants focus their activities and operations on customers and their individual welfare with suitable support services.

The pursuit of a free market in electricity is a long term task. As Australia's population increases and more individuals become available to provide services currently provided by regulated and government owned enterprises, there will be further pressure to deregulate the economy to free up controls on electricity suppliers. Also, the increasing demand for electricity will put further pressure on government budgets as more sophisticated technologies particularly renewable energy technologies are used to supply electricity. This was the case for Australia's major airline businesses that were owned by the Commonwealth Government. New technologies, fuel prices and aircraft made the running of airline businesses too expensive for taxpayers who demand lower taxes.

The Productivity Commission's Inquiry needs to point to a range of regulatory imposts and government interventions that inhibit development of electricity markets. These matters raise the cost of electricity supply and inhibit proper negotiations between suppliers and consumers for the best product possible. There exists a "paternalistic" or "maternalistic" approach by suppliers in their dealings with consumers. This is particularly the case for rural consumers seeking the connection of mains power to their properties. Being required to pay excessive prices to install mains power, the landowner is not allowed to own the electricity installation. The service provider retains ownership even though it has not funded the project installation. This situation needs to be undone and corrected to lower prices and for individuals to negotiate with the supplier for a suitable outcome.