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Philip Weickhardt
Presiding Commissioner
Productivity Commission
Locked Bag 2 Collins Street East
MELBOURNE VIC 8003

Dear ~~Mr Weickhardt~~ Philip

AER response to Productivity Commission further information request

During the AER's appearance at the Productivity Commission's public hearing for the Electricity Network Frameworks Review in Sydney in December, Commissioners requested further information from the AER on AER resourcing, our views on price caps versus revenue caps, and our thoughts on short term solutions to congestion issues.

Subsequently we have discussed and / or provided further information to Productivity Commission staff on each of these issues. This letter provides a formal response on the AER resourcing and price caps versus revenue caps issues. Further material on congestion issues will be provided separately shortly.

AER resourcing

At the hearing on 3 December 2012, we undertook to provide further information on AER resourcing and respond to some of the claims made in submissions around the lack of transparency around the AER's resourcing, staff turnover and capability.

Table 1 shows AER staff numbers in the past five years (as at 30 June).

Table 1 – AER staff numbers, 2007/08 – 2011/12

Year	Staff numbers (as at 30 June)
2007/08	83
2008/09	111
2009/10	112
2010/11	110
2011/12	129

The table shows a significant build up in staff at the AER over this time. It demonstrates two distinct increases in AER staffing – the first in 2008/09 which largely reflects greater distribution regulation responsibility and the second in 2011/12 which largely reflected preparations for the AER assuming retail responsibility.

We note that this current staffing is supplemented by approximately 10 other ACCC staff working directly on AER matters. There is also a range of other ACCC staff that spend some time working on AER matters, such as legal, corporate and IT staff.

Table 2 provides details of funding received by the ACCC for the AER (net of efficiency dividends and adjusted for parameter movements).

Table 2 – Funding received for the AER ($'000)

Year	($'000)
2013/14	32,321
2014/15	30,492
2015/16	30,361

This table includes the further funding for the AER that was announced at December's COAG meeting.

Table 3 shows AER staff turnover in the past five years. It demonstrates relatively low staff turnover in each of the past four years.

Table 3 – AER staff turnover, 2007/08 – 2011/12

Year	Staff separations	Staff turnover (%)
2007/08	12	14.46%
2008/09	9	8.11%
2009/10	8	7.14%
2010/11	10	9.09%
2011/12	12	9.30%

This pattern of low staff turnover is likely to continue in 2012/13. Indeed, for the first six months of 2012/13 there have been no staff separations.

The AER's staffing arrangements are flexible and accommodate a range of mechanisms designed to attract and retain staff. These mechanisms include individual flexibility arrangements, which allow employees to negotiate remuneration, allowances and leave entitlements, and special salary levels, which allow a special rate of salary to be paid to high performing employees and employees with special knowledge, skills and qualifications. Many AER staff are on these arrangements. We believe that the flexibility provided by these arrangements gives us the ability to attract and retain appropriate staff.

The current staff of the AER has a diverse range of relevant experience. Staff have been recruited from other energy regulators (both state utility regulators and international energy regulators (such as the Office of the Gas and Electricity Markets (Ofgem) in Great Britain). Staff have also been recruited from consulting firms and the energy sector.

The AER also has mechanisms in place to ensure that it keeps up to date with regulatory best practice and builds on its technical knowledge.

There have been staff exchanges between the AER and AEMO, and between the AER and international regulators. For example, the AER currently has a formal staff exchange / secondment arrangement with Ofgem. To date, three AER staff have had secondments at Ofgem (one is there presently) and three Ofgem staff members have been with the AER (two staff are here currently). Secondments range from 6 – 12 months.

The AER is also involved in a range of international energy fora. The AER attends the World Forum on Energy Regulation and also participates in the working groups under this forum. The AER hosts the website for the Energy Intermarket Surveillance Group (EISG) and participates in all EISG meetings.

Price caps versus revenue caps

At the hearing, we undertook to provide further information to demonstrate why the AER supports the use of revenue caps rather than weighted average price caps (WAPCs) for electricity distribution network service providers (DNSPs) within the NEM.

In essence, we consider that the benefits of revenue caps outweigh the benefits of WAPCs for electricity DNSPs.

We believe that the benefits of WAPCs rest on a theoretical argument that they provide an incentive to set efficient prices. This theoretical argument does not apply in practice because the assumptions underpinning the WAPC incentive do not apply to electricity DNSPs within the NEM. Furthermore, based on analysis of pricing in the current and previous regulatory periods, we do not consider that the WAPC has generally resulted in, or created an incentive for efficient pricing.

DNSPs under a WAPC are able to retain revenue recovered above the expected revenue calculated by the AER. Theoretically, this provides DNSPs with an incentive to set prices efficiently. That is, DNSPs are able to increase profit by reducing the price on price sensitive services towards short run marginal cost.

When a DNSP reduces the price of any service(s) under the WAPC it is allowed to increase the price on another service(s). The DNSP can therefore increase profit by simultaneously decreasing the price on price sensitive services and increasing the price on price insensitive services. This is because customers of price sensitive services are likely to respond to lower prices by using more of those services. The decrease in a DNSP's revenue caused by it lowering prices is therefore offset by the increase in sales. Meanwhile, customers of price insensitive services are likely to respond to higher prices by using the same amount, or only slightly less, of those services.

The problem is this theoretical argument does not apply in practice because it requires a number of assumptions which do not hold for electricity DNSPs within the NEM. These include:

- DNSPs have the expertise, incentive, infrastructure and independence to set prices to maximise profit:

- DNSPs must have the expertise to estimate the price sensitivity of different services (and components of services) and adjust prices accordingly

- DNSPs objective in setting prices must be to maximise profit

- DNSPs must have, or have the ability to install the necessary metering technology to provide cost reflective tariffs

- DNSPs must be free from outside influence to set profit motivated prices

- Pass through of distribution costs to consumers

  - Where retail price regulation exists often retail charges do not reflect the underlying structure of network costs and changes in network prices are not passed through to consumers

  - Distribution charges represent only part of network charges. Where DNSPs have discretion to set transmission and other charges, which do not fall under the WAPC, these charges may be adjusted to impact network charges

- Fully informed consumers

  - Consumers must know of price changes when they happen. Particularly where retail price regulation exists many consumers do not see price changes until bills are received midway through the regulatory year.

  - Consumers must be capable and incentivised to respond to price signals. Where complicated price structures exist (such as inclining block tariffs) many consumers are not capable of understanding the price they are being charged for electricity usage.

The AER considers that these assumptions do not hold for the majority of electricity DNSPs within the NEM. Without the incentive to set, and the ability to implement efficient prices the detriments of the WAPC outweigh the benefits. These detriments include price instability, bias against demand side management and recovery of revenue above efficient cost. It is worth noting that these issues are not new to the WAPC. In fact, it is the potential to recover above efficient cost that theoretically drives the incentive to set efficient prices. The problem is that at the moment these detriments are occurring without the benefit of an increase in pricing efficiency.

We also note that if the WAPC does provide an incentive to set efficient prices, the two approaches recommended by the Productivity Commission appear to be inconsistent. That is, the Productivity Commission recommended the pricing principles explicitly state long run marginal cost (LRMC) as the parameter to base prices on. The Productivity Commission then recommended WAPCs for all DNSPs. Where the above assumptions hold, WAPCs provide an incentive to set prices at short run marginal cost (as detailed above). If these two approaches were adopted DNSPs would face conflicting incentives from the control mechanism and the NER. The AER therefore considers that if LRMC is the parameter on which prices are to be based a WAPC is inappropriate.

Finally, we note that a review of the pricing principles in the NER resulting in a more prescriptive set of pricing principles is likely to occur in the near future. We believe that a revenue cap is the appropriate mechanism to facilitate the introduction of such principles. That is, a more prescriptive set of pricing principles will provide DNSPs with an obligation to set efficient prices and a revenue cap will reduce the risks that DNSPs will face when implementing such prices. This will allow the DNSPs to introduce time of use pricing, and innovative pricing strategies without the risk of lost revenue, which will likely be substantial.

Yours sincerely

Michelle Groves
Chief Executive Officer