



16 April 2012

By email: electricity@pc.gov.au

Productivity Commission
GPO Box 1428
Canberra City ACT 2301

Dear Commissioners

Submission to the Electricity Network Regulation, Issues Paper

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Productivity Commission's (the **Commission**) Electricity Network Regulation, Issues Paper (the **Issues Paper**).

In summary, Consumer Action is pleased that the Commission is investigating electricity networks and the use of benchmarking as a means of achieving the efficient delivery of network services and electricity infrastructure. This submission does not attempt to assess specific benchmarking indicators; rather it seeks to present Consumer Action's broader views on the need for changes to the National Electricity Rules (the **NER**), the Australian Energy Regulator's (**AER**) powers, and related regulatory mechanisms.

We believe benchmarking can provide a useful addition to current regulatory price setting mechanisms. Enhanced information and transparency about regulated network businesses can benefit the regulatory process as well as improving the behaviour of network businesses. A better-informed regulator will produce more efficient price setting, while comparative analysis and reporting on the network businesses' performance by the regulator can create an incentive for the network businesses to 'self-discipline' as a result of competition-by-comparison and brand protection.

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. We provide free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and are the largest specialist consumer legal practice in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

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We also operate MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians experiencing financial difficulty.

Benefits of benchmarking

Consumer Action strongly supports the development of benchmarking to be one of the tools the AER can utilise to enhance its price determinations, and as such provide a means to achieve efficient delivery of network services. While we recognise the challenges in developing appropriate indicators and problems relating to the quality of historical data, we do not believe these are valid reasons for deferring benchmarking as a regulatory approach altogether.

As such, the risks mentioned above should not prevent the development of a benchmarking approach however they may influence the way the AER should use the benchmarking results, i.e. how it is applied in practice. Benchmarking models need to be regarded as fair and reasonable in order to be legitimate tools for the regulator to use in price determinations, especially if the benchmarking results 'automatically' impact on a network business' revenue allocation. However, benchmarking results can also be used to allow the regulator to request further information. Consumer Action believes an appropriate first step to sophisticated benchmarking approaches should be to ensure that the regulator has more information combined with the ability to request further information/evidence from network businesses that under-perform. The onus should then be on the network businesses to justify and prove their case (in relation to revenue proposals). As such, Consumer Action does not suggest that the use of benchmarking should only occur in its most general form (measuring a business' efficiency against a best-practise reference point), we recommend that the application of the results should influence the powers of the regulator and place a greater burden of proof on inefficient businesses. To use the Commission's terminology, this approach would be in-between using benchmarking as a 'source of information' and an 'explicit regulatory instrument'. We believe, however, that benchmarking can be used as an explicit regulatory instrument (and there are several overseas examples of this) but if the data collected to date is regarded as too unreliable our proposed approach of using benchmarking to explicitly empower the regulator is something the Commission should consider.

We strongly believe the AER needs more and better tools in order to ensure efficient delivery of network services. As we have raised in our submission to the Australian Energy Market Commission's (**AEMC**) Directions Paper on network Rule change proposals, the on-going increases in electricity prices, and in network costs in particular, mean that improvements to the regulatory mechanisms are not only overdue but also urgently needed. The current transfer of wealth from electricity consumers to company shareholders (whether they are private companies or government owned) cannot continue and we urge the Commission to recognise the dire need for reform.

The AER does consult with consumer representatives during price determination processes, however consumer groups will never have the resources, expertise or information required to adequately balance the network businesses cost proposals. As such, we rely on the AER to be informed and empowered to be 'our proxy' in these processes. Unfortunately, the National Electricity Rules (the **Rules**) currently restrict the AER in the decision-making process to the detriment of consumers across the National Energy Market (**NEM**). Consumer Action believes

the introduction of benchmarking combined with appropriate Rule changes is the way forward to achieve efficient network services.

In relation to the numerous reviews currently looking at similar issues the Commission asks: “Given the various ongoing reviews and the consultations associated with them, how can the Commission best add value? Do these reviews have the same broad objective as the Commission or are they more narrowly focused?”¹

Consumer Action believes the Commission can add significant value by including a broader consideration of benefits to the community as a whole. We would like to remind the Commission of its 2005 Review of National Competition Policy (**NCP**), a policy which was an important precursor to the independent economic regulation of essential infrastructure including electricity. In that review, the Commission outlined number of key benefits of Australia’s micro-economic reform program for consumers, including improved productivity, sustained economic growth and increased consumer choice. The Commission noted, however, that ‘experience with NCP reinforces the importance of ensuring that the potential adjustment and distributional implications are considered at the outset’.² The Commission noted the ‘mixed impacts’ of reforms on regional communities and adverse impacts on the environment (such as increased greenhouse gas emission from the reform-related stimulus to demand for electricity).

It is our view that the National Electricity Objective (**NEO**), with its narrow focus on the economic interests of consumers,³ institutionalises an inability of our market institutions to consider adjustment, distributional and equity impacts of regulatory decision-making. This is because the NEO focuses these institutions on supply-side efficiency and investment matters, rather than broader consumer and public interest outcomes. Reviews undertaken by the AER and the AEMC are by law restricted to only consider issues relevant to the National Electricity Objective (**NEO**), while the Commission does not have this limitation. Although we note that the terms of reference (**ToR**) requests the Commission to “assess the use of benchmarking as a means of achieving the efficient delivery of network services and electricity infrastructure to meet the long-term interest of consumers, consistent with the NEO”⁴, we hope the Commission does not apply a narrow interpretation of the ToR, and take the opportunity to assess reform initiatives (such as benchmarking mechanisms and associated Rule changes) in terms of broader social, economic and environmental needs and benefits to the community.

Process for approving expenses

In relation to the reasonability test, the Rules require the AER to approve a proposal where the spending *reasonably* reflects efficiency, prudence, and rational expectations of demand and cost inputs (as per the capital expenditure criteria in Chapter 6). The Commission states that: “[s]uch a bias may be appropriate if the costs of regulatory error are greater for cost underestimates than cost overestimates”.⁵ Consumer Action stresses that the actual cost to

¹ Productivity Commission, Issues Paper, p 6

² Productivity Commission, Review of National Competition Policy Reforms (Report No 33), April 2005, p 150

³ Brody, G., ‘Consumer Interest in the National Energy Market: A Changing Climate?’, in Cantley-Smith, R., and Bowman, D. (eds), *Green Power: An environmental audit of the national electricity market*, 2009.

⁴ Productivity Commission, Issues Paper, p III

⁵ Productivity Commission, Issues Paper, p 22

consumers due to such cost overestimates is significant, and we urge the Commission to consider the impact on the community more broadly. As raised in the Commission's Issues Paper, rising electricity prices are largely driven by network costs. We hope the Commission considers these cost impacts on end users (whether they be households or businesses) and the affect they have on the community, as well as the economy, more broadly.

Consumer Action understands the need for evidence based policy and rule making. However, we do also believe that the aim to obtain 'hard evidence' in relation to network expenditure creates part of the problem. To prove that network businesses are strategically 'gold-plating', underspending capex, deferring capex etc. in order to maximise their profits is almost impossible. Consumer Action's view is that rather than seeking evidence, the Commission (as well as other organisations such as the AEMC) should assess whether the distribution businesses have the opportunity to behave this way under the current framework, and if so, it should be assumed that a rational business would be seeking to maximise their profits. We note that several of the authors mentioned in the Commission's issues paper (e.g. Littlechild and Mountain) have described such opportunities, and thus incentives, for the network businesses. The emphasis should thus be on how the Rules can be improved and how the AER can be empowered to remove, or at least reduce, the opportunities for the businesses to behave in this manner.

Further to the issue of proving actual business behaviour, another issue often raised is whether it is the AER's interpretation of the Rules or the Rules themselves that cause the problems identified by the AER. The Commission states: "It should be emphasised that network businesses and their peak bodies have strongly contested the AER's claims about flaws in the Rules, arguing that the AER's concerns appear to reflect its interpretation of the Rules, rather than being an explicit feature of them."⁶

Consumer Action believes it is of limited importance whether the AER already has the powers or discretion to achieve the outcomes it is proposing. If the AER does not believe it has, it will not act as such, and hence the outcomes will not be achieved.

Benchmarking to get information vs. providing incentives

Consumer Action recognises that there are potential challenges for comparing distribution businesses within the NEM. Clearly there are some major differences between distribution businesses in terms of lines, customer density, physical coverage, geographic location etc. Citipower in Central Melbourne and Ergon Energy operating across vast areas of Queensland are examples of two extremes. Furthermore, ownership arrangements may also impact on how the businesses respond to incentives, albeit we believe this aspect is less important in the context of the benchmarking model we are supporting. In order to compare like for like, some categories for similar network businesses ('similar x-factor') may be required. However, with a relatively low number of network businesses to start off with, this may cause a particular challenge for the NEM that has been more easily overcome in overseas markets.

There is also no reason to believe that benchmarking will completely eradicate information asymmetries between the regulator and the network businesses. As discussed above, if the

⁶ Productivity Commission, Issues Paper, p 22-23

network businesses are provided with an opportunity to increase their profits, we should assume that they would. It is thus important to be mindful of this when designing benchmarking mechanisms, but even more so when interpreting and applying the results. If given the opportunity, we can assume that the network businesses would seek to strategically influence the benchmark indicators and as such the result could be just another layer of 'gaming'. Consumer Action still sees the benefit in benchmarking if it provides the AER with reliable information that it currently cannot obtain. However, this will clearly demand great data accuracy. In our view, the key issue at an early stage of benchmarking is thus how the regulator uses the information. This is where we believe a cautious approach is appropriate. Basically, the regulator should use the information with some caution but be given the opportunity to investigate if the benchmarking indicates inefficiencies. This means that the AER should not have to approve a spending proposal by a distribution business with poor performance just because it is meeting the 'reasonableness criterion' discussed above.

Consumer Action does not at this stage support the introduction of a benchmarking scheme in order to introduce broad based incentive regulation (i.e. where the network businesses are rewarded if performing above a certain level).⁷ Incentive based benchmarking should only be used as pilots for specific projects (e.g. a smart meter roll-out) as we do not believe the level of data required for such direct interpretation and application of the results currently exists. That said, we would welcome a future AEMC review of data and benchmarking in order to ascertain whether benchmarking should be directly linked to incentive regulation.

Accounting for the future

This submission has focused on broader benchmarking issues raised in the Issues Paper, however we also wish to make a couple of comments in regards to the Commission's discussion of demand side initiatives and future reforms to the energy market.

First of all, while we recognise that there has been significant work undertaken in terms of demand side initiatives, many of these are still at a very early stage of development and thorough cost-benefit analyses are yet to be undertaken. The Commission should thus not 'simply assume' that all of these measures will be implemented and that the only issue is when. We are somewhat concerned about the Commission's statement: "Collectively, these changes are likely to affect the utilisation and nature of the network system that transports the power, and ultimately the prices borne by end users."⁸ Consumer Action has participated in many of these debates (especially in relation to smart grids) and it is evident that these demand side initiatives need to be carefully assessed in terms of cost to consumer (i.e. cost of new technology) and benefits to end users. Furthermore, it must be noted that costs and benefits are unlikely to be evenly distributed, and any assessment must therefore consider to what extent various classes of consumers can benefit and where the cost is allocated.

Finally, we note the Commission's view that distributed generation may provide some competition to the networks albeit this is still a long way off. Consumer Action would like the Commission to consider options that could bring this forward as well as identifying the current

⁷ Note that Consumer Action has taken an interest in Total Factor Productivity (TFP) regulation in the past and been supportive of appropriate data collection and analysis in order to re-consider TFP in the future.

⁸ Productivity Commission, Issues Paper, p 36

restrictions to this innovation developing.

Should you have any questions in relation to this submission, please contact me on 03 9670 5088.

Yours sincerely

CONSUMER ACTION LAW CENTRE

A handwritten signature in black ink that reads "Gerard Brody". The signature is written in a cursive, flowing style.

Gerard Brody
Director Policy & Campaigns