

5 October 2012

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Australian Energy Market Commission
Level 5, 201 Elizabeth Street
SYDNEY NSW 2001

Dear Commissioners

Economic Regulation of Network Service Providers—Draft Determination

We welcome the opportunity to provide comments on the Draft Determination of the Australian Energy Market Commission (**Commission**) in relation to the Economic Regulation of Network Service Providers Rule Change (the **Rule Change**).

In summary,

- we strongly support the proposed changes in relation to the determination of operating expenditure and capital expenditure allowances, particularly the proposed change to clause 6.12.3(f);
- we are broadly supportive of the proposed changes to the rate of return framework, but are concerned that the appeals framework limits the ability of the rules to facilitate rate of return decisions that are in the long-term interests of consumers;
- we are broadly supportive of the proposed changes to address regulatory incentives relating to capital expenditure; and
- we are broadly supportive of the proposed changes to regulatory processes, but despite welcoming efforts to address lack of consumer engagement, we are not convinced that the Commission's approach reflects a sufficient understanding of consumer engagement and related issues.

Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action offers free legal advice, pursues consumer litigation and provides financial counselling to vulnerable and disadvantaged consumers across Victoria. 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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Capital expenditure and operating expenditure allowances

Regulator's decision-making

The Commission argues that the regulator is not "at large" in being able to reject a revenue proposal from a network service provider and replace a proposal with its own. Further, it notes that the obligation for the Commission to accept a proposal from a network service provider that is "reasonable" 'reflects the obligation that all public decision-makers have to base their decisions on sound reasoning and all relevant information required to be taken into account'.¹

While we might broadly agree with this, we do not think that a regulator should be constrained in its decision-making where it has determined that a proposal from a network service provider is less than "reasonable". This is the problem with clause 6.12.3(f) as currently drafted which states that if the regulator refuses to approve part of a network service provider's proposal, it must determine a substitute amount "only to the extent necessary" and "on the basis of the regulatory proposal". This provision represents an unreasonable constraint on the regulator when adjusting a network service provider's proposal—it means that the network's proposal has significant standing even where it is determined not to be reasonable.

As noted in our submission to the Directions Paper, it is our view that rules of this nature give the network businesses an upper hand in the determination process to the detriment of consumers (but to the benefit of their shareholders). As such, Consumer Action strongly support the proposal to remove these requirements. However, we also believe that the Commission should amend the rules further to ensure that there is a greater onus placed on the network businesses themselves to justify expenditure proposals rather than merely requiring the regulator to approve any proposal that reasonably reflects the capital and operating expenditure criteria.

Benchmarking

As we have stated elsewhere, Consumer Action believes benchmarking can provide a useful addition to current regulatory price setting mechanisms.² 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 can create an incentive for the network businesses to "self-discipline" as a result of competition-by-comparison and brand protection.

As such, Consumer Action agrees with the proposal to remove the reference to "circumstances of the relevant NSP" from the capex and opex criteria. We agree that this may unnecessarily restrict the regulator in developing and using benchmarks. Despite this, we would welcome the rules more positively requiring the use of benchmarking as the proposal appears to us limited in scope.

¹ AEMC, Draft Rule Determinations, Economic Regulation of Networks Rule Change, page 103.

² Consumer Action, Submission to Productivity Inquiry into Electricity Network Regulation, available at: <http://consumeraction.org.au/wp-content/uploads/2012/04/Submission-to-PC-Inquiry-on-Electricity-Network-Regulation-April121.pdf>

Rate of return framework

We broadly support the proposal to provide the regulator with full discretion to determine the rate of return for each network service provider subject to the general requirement that this return be based on a benchmark efficient network service provider.

However, we remain concerned about the ability of network service providers to appeal rate of return decisions, which they almost always do simply because of the large amount of money they can potentially gain. Our concern is that providing further discretion to the regulator may be meaningless unless the ability of networks to appeal as they have done in the past is significantly constrained. We note that network businesses have used the appeals system to increase revenues by some \$3 billion out of some \$58 billion over the current five-year obligatory period.³

Consumer Action acknowledges that the issue of the appeals framework is being considered separately by the Expert Panel appointed by the Standing Council on Energy & Resources, and we have provided submissions to that review.⁴ We are pleased that the Commission has sought to align its work with that of the Expert Panel review, particularly so that the rules provide for more holistic, broader decision-making, focused on overall outcomes and the long-term interests of consumers. We are particularly supportive of closer linkages between the rate of return framework and the objectives of our energy laws which focus on the long-term interests of consumers.

In its final decision, we ask the Commission to closely consider the implications of the final report from the Expert Panel. Should any revised appeals framework mean that network businesses will continue to easily appeal decisions of the independent regulator, we are concerned that the Commission will have to reconsider its approach. In our view, the Commission needs to focus on a rate of return framework that discourages network businesses from appealing the regulator's final decision. Instead, the rules need to encourage more transparent engagement in the regulator's processes with more accountability of the businesses.

Capex incentives

We are supportive of the proposal to provide the regulator with the opportunity to consider ex-post reviews of actual capex, and to exclude expenditure from the regulated asset base where the regulator determines the expenditure to be inefficient. We agree that this should improve incentives for network businesses to only expend capex efficiently, given the risk of reduction in financial returns to investors.

We are concerned, however, with the prospect of network service providers using this change to demand higher returns on equity as compensation for any investment risk caused by the proposed capex reviews. It is our view that the Commission should deal with this issue in its final decision and ensure that network businesses are not able to capitalise on this reform surreptitiously. This might be done through guidance provided to the regulator in the rules, about the development of capex reviews.

³ Expert Panel, Review of Limited Merits Review, Final Stage One Paper.

⁴ See submissions lodged at: <http://www.scer.gov.au/workstreams/energy-market-reform/limited-merits-review/>.

We are also supportive of the other proposed tools to deal with capex incentives, including the ability for the regulator to design capex efficiency benefit sharing schemes. As noted in our submission to the Directions Paper, it is our view that allowing the regulator to test new incentive schemes is likely to produce innovation and, ultimately, better regulation.

Regulatory processes and consumer engagement

We are broadly supportive of the Commission's proposals regarding regulatory processes, particularly efforts to address claims of confidentiality in proposals put forward by network businesses. We acknowledge the proposal to require network businesses to nominate reasons for confidentiality and for the regulator to issue reports on confidentiality claims. While we are supportive of this, we think much more could be done. In particular, we think protocols could be developed to allow consumer representatives that are genuinely participating in the regulator's decision-making processes to be able to review confidential material.

It is our view, however, that the proposed amendments to regulatory processes will not necessarily improve consumer engagement in regulatory decision-making, as is suggested by the Commission. Our understanding is that the primary changes to address lack of consumer engagement is to impose a new requirement on network businesses to indicate in regulatory proposals the extent that they have engaged with consumer representatives, and for the regulator to be able to take this into account when setting capex and opex forecasts. In our view, these changes are minimal, and are unlikely to result in meaningful consumer engagement—network businesses may be able to satisfy consultation with consumers by presenting their proposals to them, and there may be pressure on the regulator to accept capex and opex forecasts merely because it has been given 'consumer tick off'.


In our view, much more research and practice must be undertaken about network businesses' engagement with consumers. Such research and practice should acknowledge the reality that most consumers have very limited desire to be engaged with the technical regulatory and engineering aspects of energy service provision—consumers merely want delivery of affordable, reliable, safe and environmentally sustainable energy services. It should also acknowledge that much more resourcing is required for consumer representatives to engage in processes of the various network businesses, and that network businesses need to consider new and innovative ways to better understand consumer needs and preferences. These might include consumer surveys, direct engagement of consumer experts, and deep stakeholder involvement in business planning. In terms of consumer engagement in regulator processes, we think that a greater focus in the rules on the regulator furthering the long-term interests of consumers will go a long way to improve both substantial consumer engagement and regulatory outcomes.

Finally, while we are very supportive of efforts to improve consumer engagement, we would remind the Commission that the main driver of the existing rule change is about improving the decision-making framework of the regulator and the development of rules that ensure the regulator has the ability to make decisions that are in the long-term interests of consumers. In our view, using consumer engagement as a proxy for the development of effective rules is manifestly inadequate.

We would welcome discussing these issues further with the Commission. Please contact me on 03 9670 5088 or at gerard@consumeraction.org.au if you would like to discuss these matters further.

Yours sincerely

CONSUMER ACTION LAW CENTRE

A handwritten signature in black ink that reads "Gerard Brody". The signature is written in a cursive style with a large, stylized 'G' and 'B'.

Gerard Brody
Director Policy & Campaigns