**Jam Tomorrow? – ACT version**

Submission to: AER

From: Consumer Challenge Panel

Regarding: ActewAGL regulatory proposal 2014-19

1. **Introduction:**

The Consumer Challenge Panel (CCP) was established on July 1 2013 to be a ‘critical friend’ for the AER, by considering regulatory issues from an end consumer perspective. This process has been implemented as a part response to the information asymmetry that exists in regulatory processes, to the detriment of consumers.

The roles of CCP members include:

• advising the AER on whether a network business's proposal is justified in terms of the services to be delivered to customers; whether those services are acceptable to, and valued by, customers; and whether the proposal is in the long term interests of consumers; and

• advising the AER on the effectiveness of network businesses’ engagement with their customers and how this engagement has informed, and been reflected in, the development of their proposals.

The lack of adequate consumer engagement in regulatory decision making and a lack of emphasis on the National Electricity Objective (NEO) were common themes in a series of reports published in late 2012, including from Productivity Commission, Energy White Paper (2012), Senate review, Limited Merits review process and AEMC conducted rule change regarding network regulation. In response to limited consumer engagement, COAG also made a commitment to establish Energy Consumers Australia and the AER consulted extensively on a series of guidelines to apply to network regulatory proposals, including a requirement for meaningful consumer engagement.

The NSW and ACT distribution business are the first electricity distribution business proposals to apply the 2013 guidelines and the first to be considered by the CCP. This submission has been prepared by a subgroup of five CCP members (Ruth Lavery, Gill Owen, Jo De Silva, Bruce Mountain and Mark Henley) who have been guided by application of the National Electricity Objective, seeking the long term interest of consumers.

A separate response to the NSW DNSPs’ regulatory proposals has been lodged by the same CCP sub-panel, this submission is based on that submission, many points made for NSW DNSPs are repeated here, because we consider them to be equally relevant for the ACT.

In our deliberations and in preparing this submission we have identified a number of issues, both ‘higher order’ and ‘detail’ that warrant close consideration. We have actively sought data / evidence to be able to support our arguments; however this has not been possible in considering some issues. So we have produced this submission with three different levels of detail, these being:

1. This issue in important and we encourage the AER to further investigate, utilising their expertise,

2. Here is our opinion, as a panel of experienced participants in energy regulatory processes,

3. This is an issue for which we present data that supports the perspective that we are putting.

We also recognise that under the National Electricity Rules, the AER has the discretion to exercise its judgement in coming to a determination. We present data, opinion and experience to assist the AER in exercising its discretion and reiterate the importance of the AER taking evidence and advice from many sources, using the 2013 developed guidelines to assist in deliberation and bringing this substantive body of perspective and information together, with the discretion that the AER has to make determinations – to promote the long term interest of consumers.

This submission responds to the proposal presented by ActewAGL. We respond to the major issues, with comments regarding specific aspects of the proposal, within this context. We have also been guided by the AER Issues paper, that was released on 25 July 2014, but have structured our response around the major issues that we think are raised by the regulatory proposals.

Our view is that there is much in the ActewAGL (and three NSW 2014-19 proposals) that echoes past experience of telling consumers that there may be some short term ‘pain’, but there will be ‘jam tomorrow’. After a period of substantial increases in network prices and escalating energy bills for consumers, particularly during the 2009-14 regulatory period, ActewAGL is well placed to deliver significant cost reductions for consumers in 2014-19, rather than ‘locking in’ these significant price increases of the past, into the current period and expecting consumer gratitude for slowing the increases in costs. Rather than ‘jam tomorrow’, we opine that there is plenty of scope for some ‘jam today’ for long suffering energy consumers.

We commence with an overview of the context in which the ACT regulatory proposal was lodged, before considering major issues in turn.

The New Reality

We consider that there is a new reality facing distribution businesses (and indeed, others in the energy sector) and yet we see limited evidence that the submission from ActewAGL reflects this and moves beyond “business as usual”. The new reality is a result of changes in demand and changes in customer willingness to pay high electricity bills, leading to a need for distribution businesses to adapt to meet these new circumstances. Many consumers have already embraced solar, energy saving and demand response (where they can cut their use of power at peak times in return for a reward) – many more are likely to do so

If consumers are producing more of their own energy or needing to buy less because of energy saving then they will reasonably expect to pay less for grid delivered electricity. The use of solar and energy efficiency in effect represent new forms of competition for grid delivered electricity – the entry of new forms of competition into a market would normally be expected to impact prices. The impact of falling demand for grid delivered electricity may be mitigated if there is new demand for electricity – e.g. from electric vehicles, or greater use of off – peak water heating (to back up solar). But consumers will not tolerate charges increasing or staying the same as their usage of networks declines - there therefore has to be some serious thought into how to manage any decline in the use of existing assets and the timescale over which this should be managed. Otherwise we may see more and more consumers disconnecting completely if they can to rely on their own solar etc. The development and reduced costs of storage will make this more and more possible. Although it is likely that most customers will want the security of connection for the foreseeable future even this could change longer term, particularly if charges remain high.

Falling demand for grid delivered electricity need not be all bad for the established network businesses. There are many new business opportunities (e.g. solar, demand side management, automatic control of large loads such as air conditioning) which some are already embracing. New demands from electric vehicles could also help to keep assets more fully occupied. Not all existing businesses may be winners in these new markets and network companies are not used to operating like businesses in competitive markets - this is reflected in their consumer engagement which we address later in this paper. However, those who embrace this new reality could stand to gain, particularly if regulation can become less detailed and more focussed on the “big picture” of an effective outcome for consumers. For example, in the UK, Ofgem has developed a fast track approach to price determinations for companies that clearly demonstrate they have done what consumers want.

Regulators are expected to provide a surrogate for competition and so we consider that they too will have to adapt to and incorporate this new reality into their pricing determinations.

1. **Consumer Engagement**
   1. **Activities to date**

The consumer engagement undertaken by ActewAGL in preparing its final regulatory proposal has been evaluated in the context of the AER Consumer Engagement Guidelines for Network Service Providers. Specifically, the actions taken by the business that relates to the best practice consumer engagement principles has been reviewed. The result is that the sub-panel has identified areas for improvement for all performance aspects except two items where evaluation was not possible because insufficient material has been provided. The actions evaluated are those as provided by ActewAGL in February 2014 and June 2014, supplemented by material available on ActewAGL’s website.[[1]](#footnote-1)

We are disappointed at major weaknesses in ActewAGL’s consumer engagement relating directly to the 2014-19 proposal, section 3.3. A list of ’consumers’ engaged with is given in this section; all are industry peak bodies (eg Housing Industry Association, Master Builders Association, Property Council and Land Development Agency) who can be regarded in having a vested interest in the development costs of utilities. The other ‘consumers’ consulted were ACT regulators / government agencies. Each of these bodies is very important, but they do not reflect a diverse enough spread of consumer interest to be adequate.

ActewAGL then states in the same section; “Engagement with consumers more broadly will involve a public information session following the submission of this proposal, as well as an update of ActewAGL Distribution websites to include additional information on consultation opportunities, the transitional arrangements, the connection policy and manual as well as fact sheets containing a range of useful information for consumers.”

This paragraph is disappointing for a number of reasons:

1. The thought that it is acceptable to ‘engage’ with the largest groups of customers (residential and small business consumers) after the regulatory proposal has been lodged is ‘surprising’. It demonstrates a lack of understanding of the reason for engaging with consumers to gain their views and expertise in formulating the proposal.
2. The very passive nature of the anticipated engagement, ie information on websites also displays a disinterest in genuine engagement
3. The general approach to ‘consumer engagement’ is to provide information, eg through fact sheets and a connection policy manual. Information provision is a one way process, from ActewAGL in this instance, to consumers. Effective consumer engagement is a two way process, where both parties listen to each other and respond having heard each other.

We recognise that ActewAGL has been working on their engagement with consumers for over a decade through willingness to pay surveys (WTP), there is further action required to fully engage with the relevant parties on a much broader range of issues, and in terms of provision of information, there are some serious information gaps. We do not believe that ActewAGL is providing consumers with sufficient and relevant information as part of its consumer engagement activities and that information should be provided as part of consumer engagement activities in areas including average prices, total revenue, total profits, and quality and reliability of supply. We recommend that the AER consider this issue when assessing the ActewAGL’s consumer engagement activities.

**2.2 What ActewAGL should have done**

## Willingness to Pay

We are extremely concerned with the use of Willingness to Pay (WTP) surveys as the sole input to justify ongoing high reliability related network expenditure.

We believe that evidence of the WTP by consumers can provide useful insights on consumer preferences about competing priorities, but only where there is a legitimate business case for the expenditure in the first instance.

The sub-panel recommends that:

* the AER evaluates the robustness of any WTP information provided by businesses, particularly where such information is the principal support for specific programs or activities proposed by network businesses as part of the regulatory proposal;
* only WTP information provided through well-designed choice modelling be considered by the AER as possible support for a program or activity;
* the AER confirms that WTP information is insufficient, in and of itself, to support a proposed business program or activity;
* the AER ensures that each network business has a clear and legitimate business case for expenditure that is being otherwise based on information obtained via WTP studies; and
* the AER considers the extent to which a network business’ CEO and Board have been engaged as part of its consumer engagement activities.

Participation

It is our view that based on the IAP2 Spectrum,[[2]](#footnote-2) the predominance of energy network consumer engagement activity to date has been at the “Inform” level in the participation spectrum. We would expect to see more effort by the businesses to engage consumers at the “Involve” and “Collaborate” levels. Consumers and their representatives must be able to challenge the businesses through their participation; the engagement process should ensure this challenge happens. We encourage the AER to communicate to network businesses that increased efforts need to be made to involve consumers at a collaborative level.

Content

We believe that ActewAGL is not providing consumers with sufficient and relevant information as part of its consumer engagement activities, nor is the process two-way. We further believe that information should be provided as part of consumer engagement activities in areas including average prices, total revenue, total profits, and quality and reliability of supply and recommend that the AER consider this issue when assessing the network businesses’ consumer engagement activities.

It is an ongoing concern that consumers are not being clearly provided with the cost and price implications of the preferences that they express and recommend that the AER consider this issue when assessing the effectiveness of the network businesses’ consumer engagement activities.

**2.3 Ineffective consumer engagement**

Considering these comments alongside the evaluation of the sub-panel, which identified areas of improvement for all performance aspects, we have concluded that the consumer engagement of ActewAGL has been ineffective.

WTP conclusions

ActewAGL has submitted that feedback from their consumer engagement activities supports maintaining current levels of reliability. Accordingly, the distributor’s proposals include levels of capex (and opex) which, they have submitted, are intended to maintain current levels of reliability and security of supply.[[3]](#footnote-3)

The evidence used by ActewAGL to support these findings is primarily willingness to pay (WTP) surveys.[[4]](#footnote-4)

An important part of the toolkit for consumer engagement is the use of survey techniques to gauge the relative preferences of consumers between alternative program and expenditure options. Such techniques provide an indication of the WTP by consumers to achieve the anticipated benefits from a particular program or expenditure option. In this way, the associated estimate of the WTP can be used as part of a general cost benefit analysis so as to provide guidance as to whether a specific program or expenditure option should be undertaken (i.e. in circumstances where the benefits as estimated by the WTP exceed the program costs).

Estimates of the WTP to achieve a certain outcome can provide helpful information to a network business on:

* the relative benefits of alternative programs, to allow a network business to determine consumer priorities across a range of possible programmes (i.e. those with a higher WTP are generally preferred to those with lower WTP); and
* the possible benefits to consumers of a particular activity.

This highlights that WTP information, in and of itself, is insufficient to support particular activities of network businesses. Simply providing information on the WTP or potential benefits is only part of the information that is needed.

For a particular program to be undertaken, a network business should provide information on:

* the need (or driver) for the particular program expenditure; and
* how the costs of the program are outweighed by the benefits, which can include both the business specific benefits (e.g. cost savings), and the consumer benefits as estimated by WTP information.

Further, we have reviewed the WTP research used to support ActewAGL’s approach to reliability and note that the reliability study conducted in 2011/12 provided only a “preliminary assessment” and that there is an acknowledgement by the report authors that further detailed work is required.[[5]](#footnote-5) We note that the more extensive reliability research conducted in 2003 took place sometime before significant recent price increases of well over 30%[[6]](#footnote-6). Given these two considerations, we recognise some value in the WTP work undertaken but are cautious about drawing solid conclusions solely on the applicability of the WTP research to the reliability expenditure proposals of ActewAGL.

**2.4 Reliability**

We do not support the findings of ActewAGL that consumers wish to maintain current levels of reliability, due to the lack of adequate evidence to support such findings (refer to previous comments).

While we recognise that the work has not been sufficiently undertaken to determine current consumer WTP about maintaining reliability, it is our belief that consumers highly value lower prices and may even prefer lower prices even if that meant a greater risk of slightly reduced reliability. The sub-panel refers readers to the section of this report on “Consumer Impacts” which says, quite clearly in fact, that there is a large cohort of consumers that are very price sensitive, and for whom the price rises have meant a substantial reduction in consumption and commensurate loss of utility. We believe it is reasonable to conclude that this data suggests a detailed up to date WTP analysis would not adequately support ActewAGL’s submission.

Anecdotal evidence and the views of some consumer organisations suggests to the sub-panel that consumers may prefer lower prices even if that meant a greater risk of reduced reliability, particularly where any such risk is small. These alternative choices are what we would wish to see ActewAGL test with consumers. In the absence of such research we consider that the AER will need to take into account other evidence of the views of consumers in reaching its determinations in respect of customer willingness to pay for specific levels of reliability.

The AER may wish to review the extensive work undertaken on Willingness To Pay internationally, including most recently by Western Power Distribution (WPD) which found that there was some willingness to accept a deterioration of service (ie the average number of cuts going from 8 to 9 in 10 years) for a £1.33 reduction in the average bill.[[7]](#footnote-7) This indicates that there is precedence for our view that consumers may prefer lower prices for reduced reliability, where the research is according to best practice. We note that in the case of WPD, the research was conducted through Stated Preference Choice Experiments and also considered the duration and frequency of interruptions. We also observe that in the case of the WPD Willingness To Pay research, the findings from the quantitative and qualitative research were further road tested with an expert Customer Panel and a second stage of consultation. According to WPD, this “justified WPD’s primary use of WTP to ensure our investment priorities align to customers’ preferences.”[[8]](#footnote-8) We re-state that further testing of the ‘preliminary’ data from ActewAGL is required.

**2.5 Stretch Questions**

The sub-panel proposes that the AER consider the following criteria to assess the credibility of ActewAGL’s claims about the consumer engagement activities:

* Has ActewAGL’s consumer engagement program been designed to identify and effectively respond to the specific issues and concerns of different consumer cohorts?
* How has ActewAGL identified each cohort and what processes did they use to get feedback from each cohort?
* Are the CEO, Board and senior management actively involved in understanding and responding to consumer issues, on an ongoing basis?
* Has ActewAGL transparently and accurately reported the concerns and expectations provided by each consumer cohort?
* Did ActewAGL clearly explain to consumers any trade-offs and cost implications associated with their issues/concerns/preferences?
* Has ActewAGL clearly and transparently identified how it has responded (or will respond) to the issues raised by consumers?
* Does ActewAGL provide clear evidence of all of its claims regarding consumer preferences, including evidence of consumers' willingness to pay for those preferences?
* Has ActewAGL clearly demonstrated how consumer feedback has resulted in changes to its relevant strategies/decisions?
* Has ActewAGL clearly demonstrated how consumer feedback has informed, and been reflected in, the development of its revenue proposal?
* Where ActewAGL‘s regulatory proposals do not align with its consumers' expectations/preferences, has ActewAGL clearly explained why?
* Is consumer engagement integrated into the activities of the business, or is it an ‘add on’ with an additional budget?

1. **Rate of return and WACC**

The Weighted Average Cost of Capital (WACC) is the single factor that affects prices more than any other. The AER’s decision on this has a major impact on consumers in the longer term as well as affordability in the shorter term.

ActewAGL is proposing a WACC: of 8.9 with bill Increases of 3.1%pa (5,000 kwh use), these are Network only impacts.

The data shows that regulated energy network businesses are attractive to investors, even (perhaps especially) when financial markets are volatile.

This section should be read in conjunction with the paper from the Consumer Challenge subpanels 1 and 6 about rate of return, providing evidence of excessive financial returns to financiers of regulated energy networks, along with benchmarking the AER’s cost of capital against those of some overseas regulators.[[9]](#footnote-9)

**3.1 Cost of Equity**

We urge the AER to use the discretion it is given under the National Electricity Law, to set a rate of return, including cost of equity, which is in the interests of consumers as well as best meeting the rate of return objective. Our view is that lower rates of return would adequately recompense shareholders, who have enjoyed what we consider to be undue levels of profitability over recent regulatory periods, which has unacceptably impacted on prices paid by consumers.

ActewAGL has proposed a point cost of equity of 10.71%, being a weighted average of estimates using four models – the Sharpe Lintner CAPM, the Black CAPM, the Fama-French model and the dividend discount model. The range of results from these models is 10.01% (Sharpe Lintner) to 10.92% (dividend discount model.) ActewAGL has weighted these models using arbitrary weightings[[10]](#footnote-10) then back-solved from the 10.71% to observe that under the Sharpe-Lintner model the risk free rate would be 4.12%, market risk premium 7.21% and equity beta 0.91. Both of these last two parameters are well in excess of the parameters set out in the AER’s Guideline, and the methodology is inconsistent with the AER’s Guideline, which requires use of the Sharpe-Lintner CAPM as the foundation model, with the Black CAPM and dividend growth models used to inform estimates for the equity beta and market risk premium. The Guideline specifically states that the Fama-French three factor model has no role in estimating return on equity.

In developing its Guideline, the AER had regard to the NER, took into account feedback from extensive consultation, decided how to use each of the four models, and provided its reasons for this decision. We can see no clear new evidence from ActewAGL to support straying from the AER’s Guideline to the extent suggested, and therefore suggest that the AER does not admit the weighted average methodology proposed by ActewAGL into its cost of equity considerations.

ActewAGL’s weighted average methodology simply increases the cost of equity in an arbitrary way, benefiting financiers and disadvantaging consumers. It would clearly not be in the long term interests of consumers to adopt the approach proposed by ActewAGL.

The 10.01% derived by ActewAGL under the Sharpe Lintner model – the AER’s foundation model - is based on parameters of risk free rate 4.12%, market risk premium 7.21% and equity beta 0.82. The Subpanel discusses these parameters below.

Risk Free Rate

The risk free rate appears has been calculated in accordance with the Guideline. It has been calculated “Using an averaging period of 20 days until 12 February 2014”[[11]](#footnote-11) and should be updated as close as possible to the AER’s decision in November 2014. It is not stated whether yields on Commonwealth Government Securities with a 10 year term were used, and the Subpanel asks that the AER ensures these have been used.

Market Risk Premium

In its December 2013 explanatory statement to the rate of return Guideline, the AER settled on a market risk premium of 6.5%, based on historical excess returns, dividend growth models, surveys of market practitioners and conditioning variables, along with recent Australian regulatory decisions, recent Tribunal decisions, and consultant advice, with the greatest weight given to the first of these. ActewAGL has proposed 7.21%, using a weighted average of historical excess and market returns, dividend growth model and market practitioner reports, with greatest weight given to dividend growth models (which currently provide the highest estimate of the MRP). Not only has ActewAGL narrowed the sources of information, it has suggested that a mechanistic formula should be applied, and that that formula should give greatest weight to a different source different from that specified in the AER’s Guideline.

ActewAGL’s approach puts an unacceptable level of precision on the point estimate for the MRP. We urge the AER to use its discretion, and not lock into a weighted average approach that might embed a mechanistic approach into future estimation of this parameter.

Further, in the interests of setting revenues at a level that is in the best interests of consumers, we urge the AER to consider a market risk premium of 6.0% or below. We suggest a point estimate low down in the AER’s range would be more in the long term interests of consumers while still meeting investors’ rights to an adequate return on capital invested.

Equity Beta

The AER’s guidelines on WACC suggest an equity beta range of 0.4 to 0.7, with a point estimate at the top end of that range.

Professor Olan Henry ‘s April 2014 expert report[[12]](#footnote-12), commissioned by the AER as part of its Better Regulation Program, produces calculations of empirical estimates of equity beta that are consistent with the AER’s Guideline.

Henry recommends a range for equity beta of 0.3 to 0.8, slightly wider than the range specified in the AER’s Guideline. While the nineteen calculations on which Henry bases his recommended range spread from 0.3 to 1.0, they are clustered at the lower end with fourteen calculations between 0.3 and 0.5.

ActewAGL has suggested an equity beta of 0.91, back-solved from its use of a weighted average of four models to derive its overall cost of equity. When the Sharpe Lintner model is applied, consistent with the Guideline, the equity beta is 0.82. The AER’s explanatory statement to its Guideline states that “Conceptual analysis supports that the equity beta of a benchmark efficient entity would be low and below 1.0.”[[13]](#footnote-13) We suggest that while both 0.91 and 0.82 are indeed below 1.0, they are not sufficiently below 1.0 to reflect the systematic risks of the business.

Professor Henry notes that “there is little or no reason to omit data and/or partition the sample . . . [and] is of the opinion that the most reliable evidence about the magnitude of beta is provided in tables 2, 14 and 16[[14]](#footnote-14) using individual assets and fixed weight portfolios.” These results are set out in Table 1.

*Table 1 –Equity betas calculated by Professor Olan Henry, rounded and ordered by value*

|  |  |
| --- | --- |
| Table 2 | 0.3 0.3 0.3 0.3 0.3 0.6 0.7 0.9 1.0 |
| Table 14 | 0.4 0.5 0.5 0.5 0.5 |
| Table 16 | 0.4 0.4 0.4 0.5 0.7 |

ActewAGL’s equity beta of 0.82 is also based on regression estimates of beta using historical stock market data, but including US comparables. Despite the calculation giving twice as much weight to Australian beta estimates, the much larger number of US comparables skews the result higher – to over 0.8 – and well in excess of most of Henry’s calculations. This is the approach previously suggested during consultation to develop the Guideline[[15]](#footnote-15) and we see no new evidence provided by ActewAGL that could persuade the AER to deviate from its Guideline in setting equity beta for this reset.

The Guideline clearly states that overseas empirical estimates may be used as one input to selecting a point estimate from within the empirical range of Australian equity beta calculations. The overseas data relied on by ActewAGL cannot be disentangled from the Australian data, and we suggest that the AER should place most weight on its own independent expert’s report.

**3.2 Cost of Debt**

ActewAGL has proposed a cost of debt of almost 8%. We are particularly concerned about this proposal. We believe that if ActewAGL had applied the method for the calculation of the cost of debt as specified in the guidelines, a significantly lower cost of debt would have resulted.

The AER should use its discretion to depart from the Guideline where appropriate to take into account new information – such as lower debt costs – in the interests of consumers. We will be particular focussed on this and shall be preparing additional submissions on this in due course.

The Subpanel particularly notes ActewAGL’s departure from the Guideline with regard to a ten year trailing average portfolio approach. At the time of writing, the full Consumer Challenge Panel is preparing advice to the AER on this, and the Subpanel asks that this advice be taken into account by the AER once it is finalised.

In the meantime, we suggest the following for the AER’s consideration:

* In the assessment of the debt risk premium, the AER should only include BBB+ rated debt, not just BBB, and only from regulated network utilities. The data set should not include “energy” firms, such as AGL Energy, whose market risks have nothing in common with regulated network utilities.
* The AER should have regard to the evidence presented during the development of the guidelines that credit ratings for utility bonds are often a poor estimate of the likely costs (i.e. that lenders value the stability of utility earnings are willing to lend at lower rates than might be expected given their bond ratings).

**3.3 Rate of return**

The whole-of-panel advice from the CCP to the AER on WACC – details of the full paper are referenced below – suggest allowed rates of return across Australian businesses have been too high.[[16]](#footnote-16) We recognise that the businesses need to be funded and need to be able to attract investors. However, we note that the rates of return allowed in Australia are significantly higher than those for comparable businesses elsewhere and we have seen no evidence to explain why there should be such a disparity.

The CCP paper to the Board includes this statement which we consider warrants reiteration

“… the evidence presented herein seems to conclude that the industry is far more profitable than expected and that the AER has historically set higher WACC than other regulators. The evidence from equity markets is that investors are valuing regulated businesses significantly more highly than their regulated asset bases, and that lenders are lending to the regulated business at significantly lower rates than consumers are being charged. This also seems to be evidence in the share price performance of the listed network utilities.”

We noted that the rates of return allowed in Australia are significantly higher than those elsewhere, the two tables below (tables 2 and 3) consider comparable businesses in the UK and New Zealand

*Table 2. AER compared to New Zealand Commerce Commission*



*Table 3. AER compared to Ofgem (real WACC)*



If existing investors would not accept lower rates of return we are sure that there are plenty of others who would be willing to buy the companies – as evidenced by RAB multiples when companies are sold both here in Australia and in the UK. The UK evidence (energy and water) has continued even as the regulatory regime has tightened over the years.

A recent case study is the proposed acquisition of Envestra Ltd (Envestra),. APA began its attempted acquisition of Envestra in late 2013, valuing Envestra at 1.4 times its RAB.[[17]](#footnote-17) The Envestra Board rejected this bid. In March 2014, the Board then recommended a revised Offer, which valued Envestra at 1.45 times its RAB.[[18]](#footnote-18) This was however rejected by two Board members (75% Board approval was required). In early May 2014, Cheung Kong Infrastructure ( CKI) submitted an even higher offer, valuing Envestra at 1.51 times RAB. At the time of writing the transaction has yet to be finalised but is expected to be finalised soon.

These valuations suggest that investors (in this case, highly experienced market participants APA and CKI) are valuing the regulated cash flows far more highly than the AER is in its WACC decisions. In other words, the AER’s WACC is compensating investors far more generously than needed and so they are willing to pay a substantial premium to RAB to acquire those assets and the subsequent cash flows. We would emphasise here, that these investment decisions are being made in the full knowledge of the changes to the NER and NGR, the AER’s Rate of Return Guideline and the AER’s application of this Guideline to its transitional decisions on the NSW regulated networks (May 2014).

We suggest that it is essential that the AER should have regard to actual market and comparative regulatory information in exercising its discretion when determining the regulatory WACC. This recommendation is consistent with the views expressed by the consumer representatives who participated in the extensive consultation process undertaken by the AER in the development of the Guideline. The CCP believes such examination provides the AER with an objective way of evaluating the options available to it, and to exercise its discretion in doing so.

Effectiveness of Regulation

We recognise that aspects of this submission depart from the Guidelines or reiterate issues dismissed in the development of the Guidelines. However, we consider our primary duty to be to act in the interests of consumers even if this means departing from the current regulatory framework and/or suggesting the need for changes to that framework. We offer the following comments on the regulatory framework.

• We consider that there are some important limitations to the Guidelines – for example not taking into account what is happening in the real world in terms of actual customer spending, rates of return, trading data etc – all factors that we consider are material to determining appropriate allowed revenue for the DNSPs in the forthcoming period. We note however that the AER does have the discretion to exercise its judgement in the application of the guidelines and we would encourage it to do so wherever it considered that this would result in materially better outcome for consumers.

* It appears to be very difficult for consumers and their representative organisations to engage effectively with the regulatory process. The CCP, other consumer representative and individual consumers do not have the resources that the companies have to engage in detailed technical debate. We are also concerned that this emphasis on very detailed technical issues risks missing the “big picture”.

• We consider that the regulatory system needs to require companies to justify their proposals including why they need significantly higher rates of return than similar companies in other jurisdictions. We encourage the AER to go as far as it can to develop settlements that are in the interests of consumers within the constraints of the current regulatory system. However, we would also like to see the AER recommending changes for the future to AEMC, COAG etc to make the system work more effectively in the consumer interest.

• We propose a more simple approach to regulation including setting stretch targets for the companies to reduce costs. The aim should be to move away from a tendency towards micro managing the businesses, towards a simpler less intrusive form of regulation. To set some context for such stretch targets we consider that bills to customers should be falling due to falling demand for grid delivered electricity, unless there are any very good reasons to depart from this.

**4. CAPEX**

**4.1 Overview**

Capital expenditure for ActewAGL is given in figure 1, showing both actual outcomes for the most recent period and proposed expenditure for the 2014-19 regulatory period, the trend line that shows that real capital expenditure is still increasing. We are concerned that as household and small business consumers use less electricity, capital expenditure continues to rise in real terms.

*Figure 1. Historic actual and proposed future capex*

Source ActewAGL regulatory proposal, tables 7.1 and 7.3

**4.2 Major Capital expenditure**

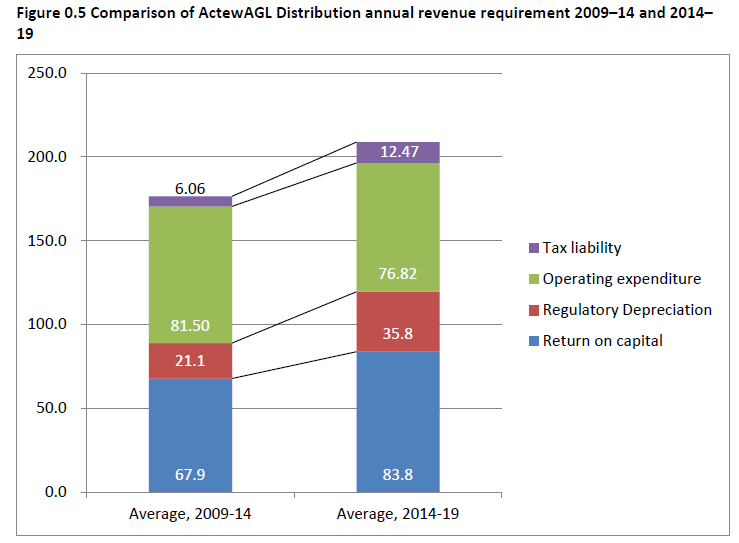
There are elements of major capital expenditure that appear high, however we do not have the capacity to fully critique these proposed expenditures:

* Pole replacement. A $50 million pole replacement program is proposed, with the rationale being that existing wooden poles are old and need replacement, and so this activity is proposed which is 40% of the asset renewal program.
* Customer Initiated Capex. This category of expenditure is mainly about new land releases for residential and commercial activity. We encourage the AER to investigate cost sharing options before any acceptance of this element of the capex program, lest existing consumers bear an unreasonable element of new development costs.
* Augmentation. A substantial capex claim of $104.3 is proposed, in particular for a new substation in the Molonglo district and for “southern supply.”

**4.3. Regulated Asset Base (RAB)**

ActewAGL is proposing a 22% increase in the size of their Regulated Asset Base (RAB) from the 2014-19 period, we consider this to be high in a market of ‘flat’ growth. Given that return on capital (a function of RAB )and depreciation are the major components of increases in annual revenue requirements (figure 2) close attention needs to be given to these by the AER.

Figure 2. Increases in 2009-14 revenue requitement compared to 2014-19 proposal



Source, ActewAGL regulatory proposal.

**5. OPEX**

There are a number of aspects of the DNSPs’ opex proposals that give us cause for concern, and as with capital expenditure we suggest some specific elements for scrutiny in assessing the proposal:

* Consumer Engagement. We do not regard the core business of ‘Consumer engagement’ to be an additional cost, it should be integrated into the day to day work of the staff teams of the any business, including energy distribution businesses.
* Costs from disaggregation of businesses. ActewAGL proposal says that higher costs will accrue to the distribution business as a consequence of splitting off ‘Ecowise Environmental’, ‘Grapevine’ and ‘TransACT.’ We do not consider it reasonable for consumers to bear any additional costs associated with management restructures or corporate cost shifting, particularly when sale prices included payments for ongoing impacts on the remaining business.
* Vegetation Management. There is no argument with the importance of vegetation management for safety in general and bushfire risk mitigation in particular, however little effort is made by the distribution businesses to explain this large expenditure of $19.4 million over 5 years. Table 7

**6. Demand / Demand Management Forecasting**

Demand

Demand, peak and overall, has been falling in recent years due to increasing use of solar, customers investing in energy saving technologies and some businesses contracting. These trends are likely to continue and could accelerate with the development of storage technologies, wider diffusion of energy saving technologies and greater development of demand management. Against these trends are some potential increases in growth from new developments (business and residential) and the wider uptake of electric vehicles. But there is the scope to manage such potential growth to avoid increases in peak demand.

Peak and overall demand therefore could and should continue to fall if better managed – the network businesses should not be passive recipients of such changes but actively be looking for scope to manage demand better and to collaborate with others such as retailers and customers to achieve this. For example they could be encouraging forms of demand side management with their customers. These changes should be achieved wherever possible through re-allocating expenditure – they should not be viewed in general as providing a case for more revenue – indeed we consider that there is real scope for exploring the potential for reductions in opex and capex allowances. There may also be scope for the regulator to look at using rewards/penalties to encourage new approached to demand management. .

We note that there could be a risk that if expenditure on opex or capex in the forthcoming period is reduced in the expectation of continued falls in peak and overall demand, but then demand instead increases, this could lead to either greater risks of interruptions to supply and/or the need for more investment (and hence costs to consumers) in the future. However, we consider that such risks can be overstated give the scope for better demand and supply balancing that we outline in this section. Indeed, in view of current and projected demand changes, we are more concerned about the potential for continued risk of overinvestment and hence unnecessarily high costs for customers to meet growths in peak and overall demand that do not occur. We are also cognisant of the fact that high prices are causing pain for consumers now – they may prefer some “jam today” in the form of lower prices rather than the prospect of “jam tomorrow” that may never arrive.

1. **Benchmarking**

If the AER is to stand as a surrogate for contestability, then it must place significant reliance on its own robust benchmarking in assessing material inefficiencies in revealed base year operating expenditure levels for each of the DNSPs and in assessing capital expenditure (in conjunction with technical engineering analysis).

Despite the efficiency improvements claimed by the ActewAGL, we are of the view that there remains fat in the proposed operating and capital expenditure as discussed in sections 4 and 5 of this report. We believe there are substantial inefficient costs in the proposals that should not become embedded in operating expenditures in years to come and in the regulatory asset base from which the greater proportion of the revenue is derived.

ActewAGL has cautioned that benchmarking is “a useful support tool to assist expenditure assessments, rather than a technique on which to base regulatory decisions. In using benchmarking as a support tool ActewAGL Distribution considers it essential for individual circumstances to be taken into account.”[[19]](#footnote-19) . It is to be expected that every business will seek to distinguish themselves and thereby diminish the importance of benchmarking by the AER. Our view is that every business will be advantaged on some measures by virtue of their operating environment, and disadvantaged on others. On balance, benchmarking is appropriate and the AER needs to continue with its plans to utilise benchmarking, particularly noting the extensive work undertaken by all stakeholders on benchmarking in developing the “Better Regulation” guidelines during 2013..

When the AER’s benchmarking report is released in September 2014, it will no doubt cause much discussion and further claims about the unique nature of each of the businesses. We urge the AER to treat these as diversionary, and focus on using the data generated from its benchmarking as evidence of the reasonable costs that consumers should bear both in the upcoming regulatory period and future regulatory periods.

We urge the AER to put resources into ensuring its internal benchmarking is thorough and robust. It is our view that benchmarking should have a very significant role in this reset.

1. **Metering**

We have considered the treatment of metering in ACT and there are several issues on which we would wish to comment.

Points of principle

Firstly, we have concerns about the appropriateness of any further “cost recovery” (whether via the RAB or exit charges) for meters that may have been in place for many years and where, therefore, costs may have already been fully recovered through depreciation charges.

Secondly, we would have concerns if there were to be any incentives on the networks to install new meters that may have an effect both on metering competition and on generating new costs to recover from consumers (whether via depreciation charges or exit fees).

Meter types 5 and 6

Sub-panel 1 supports the AER’s classification of Types 5 and 6 metering services as “alternative control services” in the Stage 1 F&As for NSW and ACT (excluding metering installation services in NSW, which are unregulated). The sub-panel believes that the AER can take further action, which will facilitate the establishment of a competitive regime for advanced metering technology.

Cost recovery of legacy metering investments

To the extent that continued cost recovery by DNSPs of regulator approved legacy metering investments is deemed reasonable, we believe this cost recovery should have minimal distortionary effects on the emerging contestable market for smart meters.

We remain concerned about a trend towards significant investment by ActewAGL in type 5 meters that could result in ActewAGL charging significant exit charges for the next regulatory period, as a minimum. The imposition of exit fees to provide for cost recovery of these metering assets would be detrimental to the emerging contestable market in smart meters and therefore, against the long term consumer interest.

AS an example, the exit fee for CT meters in South Australia has been reported to be a significant barrier to the emerging market in advanced metering technology.

In consideration of exit fees, the Standing Council on Energy and Resources (SCER) has proposed in its Competition in Metering and Related Services Rule Change Proposal Consultation Paper that an exit fee should be based on the average depreciated value of the stock of the distribution business's existing accumulation and manually read interval meters.

We are opposed to exit fees for accumulation and manually read interval meters and believe that exit fees are a significant barrier to consumers moving to adopt advanced metering technology.

Legacy metering assets replaced during the Victorian AMI program were treated as follows:

1. For metering assets installed from 01 January 2006, including accumulation meters and manually read interval meters, these assets were reflected on the newly established Metering Asset Base, and the depreciation of these assets was accelerated such that their asset life ended no later than 31 December 2013, which aligned with the proposed end of the AMI rollout.
2. For metering assets installed prior to 01 January 2006, these assets were reflected in the DUoS Regulated Asset Base, and depreciation occurred alongside all other distribution network assets, subject to the regular Electricity Distribution Price Review process. There is no evidence in this process that as the AMI rollout proceeded, the depreciation of these assets was accelerated.

We propose that for ActewAGL, leaving any residual (i.e. not already fully depreciated) value of the legacy metering fleet in the RAB is a preferable alternative to exit fees.

1. **Impact on Consumers**

In their Issues Paper for the ACT electricity distribution regulatory proposals, the AER states “we do not consider that the NEO would be advanced if prices are so high that large numbers of consumers are unable to afford the service, nor if prices are so low that investors are unwilling to supply the service.”[[20]](#footnote-20)

We suggest that there is no indication that there is a retreat of investors for Australian energy network businesses, the generous returns have been considered earlier in this paper. However, the question of consumer inability to afford the essential service of electricity warrants some consideration, particularly due to the regular media stories about households struggling to pay as a consequence of ongoing price increases over recent years.

There is lack of up to date, robust data that deals with energy stress or capacity to pay, however the ABS, General Social survey includes questions about “Financial Stress”, including inability to pay utilities bills on time. The most recent data was published in 2012, from 2010 surveys, so from a period of rising prices, but without the impacts of the last 4 years of price rises, still the data is instructive, though almost certainly understates the true extent o current energy related hardship.

Figure 3 gives the percentage of the Australian population who could not pay utility bills on time, at some stage during the previous year and is presented by equivalised income quintiles. 12.8 percent of all Australian households were unable to pay their utility bills, mainly electricity, on time in 2010, due to insufficient income to pay the bill. For the poorest 20%, 18.8% couldn’t pay on time, while for the second poorest quintile, nearly one in five (19.3%) of households couldn’t pay on time. Of concern too is that 15% of middle income households (quintile 3) could not pay on time, indicating that the stress of inability to pay energy bills on time is increasingly an issue for middle income households as well as poorer households.

*Figure 3. Inability to pay Utility bills on time*

*Source: ABC, General Social Survey, 2012*

The General Social Survey (GSS) also records the frequency of utility bill payments, with results showing that for each quintile, the mode frequency was 3-5 times for inability to pay in the last 12 month. We suggest that this coincides with quarterly electricity bills and indicates that for most household who struggle to pay their bills on time, it is for almost every electricity bill. 15.2% of households in the poorest quintile have problems paying their bill more than 3 times per year, a15.3% of the second quintile and for the third quintile 13.6% of households are unable to pay more than three times per year, as shown in Figure 4.

*Figure 4. Frequency of Utility payment difficulties*

*Source ABS, general Social Survey, 2012*

*Figure 5. Inability to pay utilities bills on time, by household type*

*Source ABS, general Social Survey, 2012*

Figure 5 considers inability to pay bills by household type. The glaring result here is that nearly 35% of sole parents were unable to pay their bills on time, and 23% of single person households below 35 years of age also struggled with energy bill payment as did 14.6% of couples with children. The data shows that some household types are affected much more severely than others: households with children, particularly sole parents have significant difficulty in paying for energy

*Figure 6. Inability to pay utilities bills on time, by household type*

*Source ABS, general Social Survey, 2012*

Figure 6 shows the frequency of energy bill payment problems. Again, families with dependent children and younger single person households have regular difficulties paying their bills. For sole parents, 29.3% were unable to pay on time 3 or more times per year, while it was 13.5% for couples with children and 18.9% for single younger people.

The number of people unable to their utility bills on time increased in comparison with the previous General Social Survey, for every income quintile other than the highest, indicating the increasing financial stress form rapidly rising energy costs being experienced by household consumers, figure 7

*Figure 7, Inability to pay utility Bills on time, 2006, 2010*

*Source ABS, general Social Survey, 2012*

High and rising electricity bills are having a significant, deleterious impact, particularly on families with children and on younger singles households.

Figure 8: ACT electricity complaints

Source AER

Since the average levels of income are higher in the ACT than other parts of Australia, there is a view by some that there is minimal social disadvantage in the ACT and so rising energy costs have minimal real impact. This is not the case as shown in figures 8 and 9, both from AER energy affordability reports. Figure 8 shows that complaints from customers, an indicator of rising concerns about energy prices, have increased in recent quarters, with 2013-14 likely to yield the highest number of complaints ever, in the ACT.

Also of major concern is the growing level of ACT customer electricity debt.

Figure 9. ACT consumers with debt, by quarter.

Source: AER

The Subpanel remains committed to ongoing debate about any of the matters raised in this submission, or other matters impacting on end consumers.

1. For details of this evaluation, refer to sub-panel 1 advice to Warwick Anderson, 2 June 2014 [↑](#footnote-ref-1)
2. This is discussed in our submission to the NSW regulatory proposals, 2014-19 [↑](#footnote-ref-2)
3. [↑](#footnote-ref-3)
4. [↑](#footnote-ref-4)
5. McNair, B and Ward, M (2012) “Balancing Costs and Standards of Service: the stated preferences of Canberra households” as provided by ActewAGL June 16 2014. [↑](#footnote-ref-5)
6. St Vincent de Paul (2014) “ACT Energy Prices July 2013 – July 2014” at <http://www.vinnies.org.au/page/Our_Impact/Incomes_Support_Cost_of_Living/Energy/ACT/> [↑](#footnote-ref-6)
7. Western Power Distribution (2012) WPD Price Review WTP Research – Quantitative Findings at <http://www.westernpower.co.uk/docs/consultation-process/stage-2/Willingness-to-pay-research-quantitative-results-i.aspx> [↑](#footnote-ref-7)
8. Western Power Distribution (2013) R11O-ED1 Business Plan at <http://www.westernpower.co.uk/docs/About-us/Stakeholder-information/Our-future-business-plan/Seperate-documents/Stakeholder-Engagement.aspx> p.24 [↑](#footnote-ref-8)
9. Smelling the roses and escaping the rabbit holes: the value of looking at actual outcomes in deciding WACC. Prepared for the Board of the Australian Energy Regulator. Consumer Challenge Panel July 2014 [↑](#footnote-ref-9)
10. Table 10.5 of ActewAGL regulatory proposal, page 274 [↑](#footnote-ref-10)
11. Table 10.3 of ActewAGL’s proposal, page 265 [↑](#footnote-ref-11)
12. Henry O. T., Estimating Beta: An Update, April 2014, available at <http://www.aer.gov.au/sites/default/files/D14%2052760%20%20Estimating%20Beta_%20An%20update%20Olan%20T%20Henry%20April%202014.pdf> [↑](#footnote-ref-12)
13. Better RegulationExplanatory Statement Cost of Capital, page 86 [↑](#footnote-ref-13)
14. [↑](#footnote-ref-14)
15. page 16 of SFG, Regression-based estimates of risk parameters for the benchmark firm, June 2013 [↑](#footnote-ref-15)
16. Op cit [↑](#footnote-ref-16)
17. “*Catch me if you can*” 23 August 2013. CBA Global Market Research Equities: Envestra. [↑](#footnote-ref-17)
18. “*ENV Board says yes, CKI says no*” 4 March 2014. CBA Global Market Research Equities: Envestra [↑](#footnote-ref-18)
19. ActewAGL regulatory proposal p223 [↑](#footnote-ref-19)
20. AER Issues Paper for ACT distribution proposal 2014-19 [↑](#footnote-ref-20)