Consumer Utilities Advocacy Centre

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Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
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By email: aerinquiry@aer.gov.au

Dear Mr Pattas

**Response to the Victorian distribution businesses regulatory proposals**

The Consumer Utilities Advocacy Centre Ltd (CUAC) would like to thank the Australian Energy Regulator (AER) for the opportunity to comment on the pricing proposal submitted by Victoria's electricity distribution businesses as part of the 2011-2015 Distribution Price Determination. This process is of great importance to Victorian consumers, as it will significantly influence the price that Victorian pay for their electricity until 2015.

CUAC is an independent consumer advocacy organisation. It was established to ensure the representation of Victorian consumers in policy and regulatory debates on electricity, gas and water. In informing these debates, CUAC monitors grass roots consumer utilities issues with particular regard to low income, disadvantaged and rural consumers.

In this submission and in future submissions to the price determination process, CUAC will be guided by the principles of affordability, access and fairness. Electricity is an essential service that everyone needs to participate effectively in society. It is important to ensure that all Victorians, regardless of their socio-economic position, are able to access the electricity supply system and afford its services. Failure to achieve this can entrench disadvantage and create significant social issues.

While CUAC acknowledges that distribution network charges constitute only one aspect of electricity affordability, there is no doubt that these charges are an important aspect. Issues of affordability and access need to feature prominently in the AER's assessment of the proposals from the distribution businesses.

Issues of fairness (equity) must also be considered by the AER in considering the businesses' proposals. Specifically, network price increases have a disproportionate impact on low income earners and electricity consumers with low levels of consumption. CUAC accepts that the most effective way of overcoming disproportionate impacts need to be addressed through government policies outside the regulatory process. However, it needs to remain a consideration as the AER assesses the proposals from the distribution businesses for increased network charges.

To support this perspective, CUAC highlights data from the most recent Bureau of Statistics Household Expenditure Survey that indicates that low-income earners pay significantly more for electricity as a percentage of their total weekly expenditure than average households. Specifically, over 2.88 per cent of household expenditure for consumers among the lowest income quintile in 2003-04 was spent on electricity and power compared with 1.91 per cent for the average household.[1] Consumer Price Index data indicates a 32 per cent price increase in electricity in Melbourne since June 2004.[2] It is likely that this significant price increase will result in electricity becoming a larger percentage of household expenditure among the lowest household income quintile in the next review of household expenditure.

Given this, it is important that careful scrutiny is given to capital expenditure proposals from the distribution businesses. The AER needs to give careful consideration to different investments and the appropriate premium that consumers should pay for reliability. In other words, the AER should carefully assess the costs of capital expenditure proposals against the benefits to ensure that infrastructure investment delivers the optimal consumer outcome.

In this submission, CUAC will highlight three particular issues of significance in relation to the distributors' proposals and to the price review process as a whole.

**Time of use tariffs**

In all of the proposals submitted by the five Victorian distribution businesses the issue of time of use tariffs is canvassed. As a result of the Victorian Government's Advanced Metering Infrastructure Rollout, it will be possible to subject small consumers (both residential and business) to time of use tariffs. Such tariffs will allow distribution businesses to charge for more for energy during peak periods. In theory this should improve network utilisation and efficiency. Customers, in order to avoid the high peak prices, will shift their load to off peak periods. This will reduce network congestion and result in a more efficient spread of consumption across the day.

CUAC has several concerns with the introduction of time of use tariffs for residential consumers.

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1 Australian Bureau of Statistics, Cat. No. 6535.0.55.001 Household Expenditure Survey, Australia: Detailed Expenditure Items, 2003-04

2 Note Consumer Price Index data is only collected in capital cities; hence the use of Melbourne based figures in this analysis. Data can be found at Australian Bureau of Statistics, Cat. No. 6401.0 Consumer Price Index, Australia, TABLE 13. CPI: Group, Sub-group and Expenditure Class, Index Numbers by Capital City

SP AusNet in their revenue proposal provided the following example of a possible time of use tariff for residential consumers.

| | Standing Charge ($/cust/yr) | Peak Energy Summer (c/KWh) | Shoulder Energy Summer (c/KWh) | Peak Energy Winter (c/KWh) | Off Peak Winter (c/kWh) | Off Peak Summer (c/kWh) |
|---|---|---|---|---|---|---|
| Single rate | 8 | 8 | 9 | 0 | 0 | 0 |
| Residential time of use | 8 | 42 | 36 | 34 | 3 | 3 |

In its presentation at the public forum on the distributors' proposals, SP AusNet suggested that this proposed tariff would be "revenue neutral" given its forecasts of demand elasticity among customers. Essentially, SP AusNet forecasts that customers will shift their loads to such an extent that the high peak prices will be offset by the lower off peak prices and revenue will remain the same as it would have been under a single rate tariff. CUAC would ask the AER to closely examine forecasts of energy demand and price elasticities submitted by distributors in relation to their revenue and pricing proposals as they relate to time of use tariffs. Such a tariff structure as outlined in the SP AusNet revenue proposal will only be revenue neutral if the forecasts associated with the tariffs are accurate.

CUAC notes that even SP AusNet highlights the difficulty in forecasting consumer response to time of use tariffs. Their proposal stated:

> "With regard to the elasticity of demand estimates, there is limited data available on the response of customers to such a tariff in Australia. Moreover, even after assessing overseas studies, it is clear that there is no correct or common 'point estimate' in relation to the impact that these tariffs will have on the amount of energy that customers consume. This is further complicated by the significant change in both price level and structure proposed by SP AusNet, which limits the ability to translate the results from other jurisdictions to SP AusNet."[3]

CUAC is concerned that there are issues that may have not been considered in the development of the time of use demand forecasts. In particular, CUAC is concerned that forecasts of price elasticity are based on assumptions of perfect information. CUAC is worried that many Victorian energy consumers are ill prepared to respond to price signals because of a widespread lack of understanding of the complexities of electricity markets, pricing and billing. If time of use distribution tariffs are to be levied, consumers need to be aware of the change and its implications. Simply implementing the new tariff structure will not change consumption patterns sufficiently because of the inelastic nature of electricity demand and because consumers are not widely aware of the type of behavioural change that is required to reduce costs through load shifting. CUAC is concerned that the AER's potential approval of time of use distribution tariffs will occur in the absence of a concerted campaign to inform consumers of the change and assistance to encourage behavioural change. The AER should work closely with industry and Government to ensure that

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3 SPI Electricity Pty Ltd, Electricity Distribution Price Review 2011-2015: Regulatory Proposal, November 2009, p. 33

appropriate measures are in place to facilitate information and consumer behavioural change in advance of any approval of time of use distribution tariffs.

In addition to the issue of demand forecasting, CUAC is concerned that there are many consumers that will be unable to shift their load and these customers will be disproportionately affected by the tariff proposals. In particular, CUAC is concerned about the potential for price shocks among residential consumers with "peaky" and inelastic electricity demand. Types of consumers that are likely to fit this consumption profile include:

- pensioners and seniors;
- the unemployed and the underemployed; and
- young families and single income households.

Households with inelastic demand, including many of Victoria's most vulnerable households, will pay significantly more for energy if time of use distribution tariffs are directly passed on by the retailer. Given that Victoria has unregulated retail tariffs, it is almost certain that retailers will directly pass through the time of use distribution tariff to their customers regardless of a customer's circumstance.

CUAC would like to draw the AER's attention to rule 6.18.5 of the National Electricity Rules on Pricing Principles, which states that:

> "a tariff, and if it consists of 2 or more charging parameters, each charging parameter for a tariff class must be determined having regard to whether customers of the relevant tariff class are able or likely to respond to price signals."

The significance of this rule is that, in developing tariff proposals, distributors must be mindful of the ability of affected customers to respond to price signals such as time of use tariffs and, by implication, to alter their consumption accordingly. If the AER is not confident that the distributor has developed its tariff proposal with regard to this rule, it can require the distributor to revise and resubmit its tariff proposal or it can unilaterally set the tariffs (Rule 6.18.8).

CUAC is of the view that, under these provisions in the National Electricity Rules, households unable to respond to price signals due to inelastic or peaky demand profiles should be offered flat distribution tariffs.

CUAC also notes the potential for businesses to be affected by time of use distribution charging. Most businesses operate during times of peak electricity demand and network congestion. The ability of such electricity customers to shift load is severely limited by the necessities of operating a business such as employing staff and aligning hours of operation with cultural/economic norms. CUAC supports close analysis by the AER of any time of use distribution tariffs for business in light of rule 6.18.5. If businesses cannot effectively respond to price signals because of the reality of their operations, there is no justification under the rules for exposing them to time of use tariffs.

**The "gold plated" network?**

CUAC does not have the resources to forensically examine each expenditure proposal from the distribution businesses. Consumer organisations place a significant degree of trust in the AER to perform this task. However, in the review process to date several issues seem salient to the AER consideration of the revenue proposals.

The first is the extent to which the network is ageing and needs replacement. CUAC supports the replacement of network assets in order to maintain supply quality and reliability as well as network safety. However, we are concerned that the distribution businesses may be overemphasising network age in order to justify an unnecessarily high level of capital expenditure. We would question, for example, why some of this capital expenditure did not occur in previous regulatory periods and why some of it cannot be deferred until the next. In a retail market characterised by increasing prices, it is important to smooth capital expenditure related price increases as far as practicable to avoid consumer price shocks. Given the proposal submitted by the Victorian businesses, it would appear that significant price rises will occur in 2011. We would emphasise the need for rigorous examination of the capital works projects proposed by the distribution businesses.

The second significant issue relates to the cost of reliability and quality. Obviously, high supply quality and reliability are desirable from a consumer perspective. However, these attributes do not come without cost. The task for the AER is to determine the appropriate price for consumers to pay for high quality and reliable supply. Each expenditure proposal that purports to improve supply quality and reliability should be carefully examined to ensure the benefits of the improved outweigh the costs to consumers.

CUAC also acknowledges the potential for non-network alternatives to achieve the same outcomes as capital investment in the network in terms of reducing congestion as well as improving quality and reliability. In assessing capital expenditure, consideration should be given to whether more efficient alternatives to that expenditure may exist. CUAC is concerned that incentive factors such as the Service Target Performance Incentive Scheme (STPIS) encourage network investment over non-network alternatives even if the non-network option may be more efficient.

Essentially, CUAC is concerned that the revenue reset process provides an incentive for distribution businesses to argue that significant capital expenditure is necessary to maintain the network's integrity. However, if this expenditure is not carefully monitored the revenue reset process could deliver a "gold plated" network at high cost to consumers without commensurate benefit. CUAC notes that the 67 per cent increase in capital expenditure for the 2011-2015 regulatory period seems significant and, potentially, excessive. The reality of delivering this high level of capital investment to the budgets set out in a skill constrained economy should also be scrutinised by the AER.

**The fallibility of forecasting**

CUAC is concerned that the ability of distributors to effectively forecast demand, expenditure, revenue and customer contributions. An examination of the data from 2001 to the present indicates that forecasting in distributors' revenue proposals to the regulator is notoriously unreliable.

For example, forecast operational expenditure in previous regulatory proposals has usually been underspent. There is an incentive to forecast high operational expenditure and underspend as it can be rewarded through efficiency carryover schemes. It also seems from a cursory analysis of past data that distributors have routinely over forecast capital expenditure. There is an incentive to do this because the businesses can invest unspent money and realise a return. However, CUAC acknowledges that this incentive is offset to some extent by the STPIS. CUAC also notes overall deficiencies in forecasting customer contributions and revenue in the past. CUAC urges the AER to examine past distributor forecasts closely to inform its decision making in this review. Such analysis should reveal whether some of the strategic behaviour adopted by distributors in the past is being repeated.

Once again, we thank the AER for the opportunity to participate in this consultation process. We look forward to further engagement and consultation during this important process. If you have any further queries please contact David Stanford, Policy Officer on (03) 9639 7600.

Yours sincerely,

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