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Sent: Wednesday, 11 September 2013 7:15 PM
To: Rate of Return
Cc: Reeves, Andrew; Tony Bellas - External; Philip St Baker
Subject: FW: Finding solutions to Australia's spiraling network costs - Better than "Better Regulation"

Mr. Warwick Anderson
General Manager—Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
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Dear Sir,

This is a personal submission in response to the publishing by the AER for comment of the final draft guideline in the consultative "Better Regulation" program initiated in December 2012. I have been prompted to make a frank personal submission, to be more direct about the failings of network regulation in Australia than would result from the natural circumspection that has to be observed by both the company that I founded and now serve as a non-executive director and of the National Generators' Forum that I have chaired for the last two years, by what I believe has been a totally misnamed and misdirected effort when viewed in the context of the stated aim of "developing an integrated package of measures to help promote the outcome that consumers pay no more than necessary for a safe and reliable supply of electricity network services" and "meet the long term interests of consumers". (Ref: the request for submission document: "AER releases draft rate of return guideline - Request for submissions")

Notwithstanding that the AER could really not achieve much more given the "rules framework" in which it is tasked with the responsibility to regulate network services costs, even following the changes in the electricity and gas rules in late 2012.

Notwithstanding the huge contributions made by so many, in the AER as well as in electricity participants and industry associations, and at great expense to everyone, including ERM Power Limited, the company that I founded, and the National Generators' Forum, which I have chaired for the last two years, the suite of draft guidelines now produced and from which the AER is required by late-2013 to produce its final "Better Regulation" guidelines, do not appear to even touch on international competitiveness of Australia's regulated electricity network service charges. It has to be said that the reams and reams of commentary seem to be more to do with "avoiding increasing uncompetitiveness" in network service costs in Australia, rather than establishing why US regulated network costs for electricity consumers, for example, are in most cases less than one-quarter of electricity network service costs approved by AER and charged to Australian businesses and residences.

At this time especially, with a change of federal government charged with the responsibility of bringing fresh eyes on the problem of Australia's unsustainable escalating electricity prices, the draft guidelines must be viewed as minor tinkering on the sidelines and not attending to the serious flaws in the rules that are producing this crippling attack on the competitiveness of Australian industries and manufacturing, as well as significantly affecting the standard of living of all Australians.

At this time a new government will want to understand what changes in the "rules" are necessary, as well as in the application of the rules, to achieve internationally-competitive electricity network service charges, and not be presented with a **misnamed "Better Regulation" that is supposed to "promote the outcome that consumers pay no more than necessary for a safe and reliable supply**

of electricity network services” and “meet the long term interests of consumers”, without any reference to the comparative charges that other trading partners enjoy.

There are plenty of flaws in the electricity network regulatory rules that are well recognised, and well known also to the AER as handicaps under which their regulatory efforts have to be applied. I want to only touch, very briefly, on two aspects, namely **“Replacing the DORC with DC”** and **“Removal of metering derogations, and consultation between networks and retailers to enable retailers to offer ‘smart bundled tariffs’**

“Replacing the DORC with DC”

The primary reasons for the failure of network regulation in Australia, in my view, has been the guarantee of a WACC return not only on a network asset base notwithstanding what energy and demand growth or decline might emerge, but that this approved WACC is applied to the revalued “replacement cost” asset base.

I have had another opportunity to spend a week in the USA, including time to review why the US has been able to keep retail electricity prices down to 10 to 12 ¢/kWh (including all taxes), compared to Australia’s run-away prices, approaching three-times US rates for residential and small business premises. 18 months ago I had a week in San Diego at an industry conferences and meetings to learn that residential prices across most of America were circa 10 ¢/kWh, and have followed my daughter’s residence prices in Scottsdale, Arizona, still only nudging 11 ¢/kWh. I had the opportunity at first hand in June this year in Washington DC, one of the many cities supplied out of the PJM, to understand how this city gets wholesale electricity to the city from the PJM at 9.22 ¢/kWh (generation plus transmission), with just a 2.14 ¢/kWh regulated city distribution charge and 1.06 ¢/kWh retail plus tax and other minor on-costs. I have attached the latest retail electricity price details from Pepco, the monopoly DNSP, and also some sheets from PJM regarding the latest capacity and energy auction, based on which PJM is able to supply to the many cities and towns connected to this huge transmission network.

More particularly, the issue for Australia is why residential retail electricity prices in the NEM have increased from close to only double wholesale prices dispatched from power stations in 2000, to closer to six-times wholesale prices (carbon-exclusive) today, with network costs increasing three-fold, carbon & green on-costs representing a virtual doubling of (carbon-exclusive) contract wholesale generation costs, and regulated mass-market retailing gross margins reflecting gross inefficiencies from State government regulations, especially for those mass market residential and small business customers not able to access contestable rates directly from retailers. There is also the additional regulated default mass market cost component, above actual contract wholesale generation costs, to allow for supposed new-entrant generation costs, which have become a bone of contention in the various State price cap determinations.

The C&I electricity market, representing half total energy sales in the NEM, has exemplified how the fully-deregulated competitive wholesale electricity market has delivered internationally-competitive generated power and energy prices, currently delivering wholesale generation cost components of retail electricity rates for C&I customers at a lower (current dollar) rate than at the inception of the NEM, with no LRMC margin on generation cost and with less than 0.5 ¢/kWh retail gross margin, one-tenth of the mass market retail

gross margin.. The pass-thru of regulated network costs to C&I and other Business Energy consumers however now adds more than twice the (carbon-exclusive) contract wholesale price, and up to four-times, and more, for some Small Business Energy consumers. The regulated network costs passed thru by retailers to C&I customers are as plainly grossly uncompetitive with international standards as for mass market customers, and cannot be explained by low population density nor overdue reinvestment. A comparison with the USA demonstrated that these unsustainable network costs in Australia are directly due to gross over-investment on networks to achieve unrealistic reliability standards, and the application of the regulated WACC to the revalued non-depreciated asset base. As a consequence of the tripling of retail electricity prices over the last ~12 years, the significantly reducing electricity demands across Australia has exacerbated the impact of regulated networks being guaranteed a regulated WACC on this asset base and bearing no risk of over-investment if its assumed growth does not eventuate.

Nowhere in the world, to my knowledge, are electricity network owners offered long-term returns on network investments at as-new costs of assets with useable lives hugely longer than debt amortisation terms. This virtual peculiarity in Australia is further exacerbated because of the much lower taxation depreciation rates in Australia, which create a much larger non-depreciated asset base to be revalued to as-new costs and on which the regulated WACC is applied.

As importantly, the network price regulation on the basis of a WACC on a DORC is a model of financial return for private ownership of an essentially low-risk highly capital-intensive natural monopoly providing an essential service to residences and businesses which is totally out-of-step from the intrinsic costs of financing such long-life public infrastructure, and out-of-step with regulated privately owned electricity networks in the USA. In the case of public ownership of electricity networks and in the case of regulated US privately-owned networks, network service charges were and are based on an equivalent WACC on a taxation-depreciated asset cost, with only O&M and refurbishment costs beyond the period allowed in regulated network charging for amortisation of the asset financing.

I can only conclude that network charging on the basis of a WACC on a DORC, in lieu of on a DC (ie on taxation-depreciated cost of each approved new asset expenditure), represents a guaranteed internationally uncompetitive pricing model for electricity networks, and which along with the guarantee of a WACC on over-expenditure notwithstanding what energy and demand growth or decline occurs on the networks in Australia, have combined to produce exponentially-rising network charges. Exponentially-increasing network charges, along with the propensity of governments to tax electricity assuming it is inelastic, resulting in unsustainable uncompetitive electricity pricing in Australia, have shown just how elastic business electricity use is to such price when price rises to more than twice that in business competitor countries

Removal of metering derogations, and consultation between networks and retailers to enable retailers to offer ‘smart bundled tariffs’

While the AEMC Power if Choice review, approved by SCER provided for open competition in metering and meter data management services for residential and small business consumers, a framework for open access, interoperability and common communication standards for smart meters to support competition, and a phase in of efficient and flexible

pricing options for residential and small business consumers based on formal consultation processes between network businesses, retailers and consumers, there is a chorus of criticism as to the delays in implementing these aspects of electricity reform with bearing on “better regulation”. Such criticism includes observations recently by the Productivity Commission “that many of these essential measures have been frustrated by complex processes, constant and over-lapping reviews, and a lack of agreement between relevant governments.”

I must add my personal observation that obfuscation which serves to delay the practical implementation of these measures to enable retailers to devise different fully-bundled (energy + network) electricity tariffs which incentivise smaller customers of different levels of electricity use to opt off regulated tariffs and on to appropriate cost reflective tariffs and incentivise DSP, and to facilitate the retailer roll-out of “smart meters” to smaller customers along with appropriate “smart tariffs” and “smart customer communication”, seem to have led to the resort in the AEMC Power of Choice Review to recommend supporting changes to improve the ability of the market to maximise the potential for efficient DSP, such as follows, but which I would consider less effective and sub-optimal proposals advocated by third parties which would add to the delivered price of electricity.:

- Allowing consumers to sell their DSP to parties other than their electricity retailer by introducing a new category of market participant
- Establishing a transparent framework for third parties offering demand management services in the National Energy Customer Framework:
- Developing a set of national ring fencing guidelines, the AER should consider the value of allowing distribution businesses to own and operate distribution generation assets

While there is a role for these initiatives in the reform of the electricity market rules, it is much more important to give effect to the open competition in provision of metering services and to initiate compulsory consultation between retailers and network businesses to deliver more appropriate network tariffs as part of fully-bundled tariffs which retailers can offer to suit the scale and type of small consumer electricity use, to attract small consumers off regulated tariffs and facilitate the essential improved communication with consumers by way of monthly billing and “smarter electricity use” prompting by retailers for facilitate greater DSP and better use of networks.

Governments and relevant agencies are actively seeking solutions to current unsustainable electricity prices, The freeing up of metering and meter data management services to competing retailers and the effective consultation between network businesses and retailers in flexible network tariffs to enable retailers to tailor fully-bundled energy plus network tariffs, are two of the most urgent action needed to enable retailers to offer mass market residential and small business customers smart monthly billing and superior customer communication to transition these electricity consumers to improved demand-side management of power demand, lower electricity supply prices and superior customer satisfaction.

The fact that there is unanimity among competing retailers and generally across the industry as to the compelling case for removal of any exclusivity for DNSP’s, and that these efforts have been obstructed at every step by bureaucratic obstacles, is hampering essential reform in the regulated electricity sectors, and relief from the current unsustainable electricity price rises in Australia.

This is why I believe that it is totally inappropriate to term as “Better Energy Network Regulation” directed to ensuring that “consumers pay no more than necessary for a safe and reliable supply of electricity network services” and “meet the long term interests of consumers”, the present AER review of network expenditures, rates of return on capital expenditures and on direct consumer engagement by network service providers. The latter guideline for consumer engagement by network service providers in particular seems to be contrary to the AEMC’s Power of Choice review, endorsed by SCER.

Retailers have the primary contact with electricity consumers, and customer satisfaction is the primary aim of competing retailers. That is why I advocate strongly that one of the most important reforms for network is the removal of metering derogations which networks have enjoyed, and the implementation of compulsory consultation by networks with retailers to enable retailers to offer ‘smart bundled tariffs’ to incentivise the greatest possible level of DSP to benefit Networks.

It is quite alarming to hear of representations by network businesses that because customer use of their networks is falling there is diminished interest in DSP in networks with excess surplus capability. This is surely a recipe for continuing electricity decline and acceleration of the fall in customer use of their networks.

Yours faithfully,

Trevor St Baker