Network regulation for all:

Submission to the AER's preliminary *Framework and approach paper for Ausgrid, Endeavour Energy and Essential Energy*

10 August 2012

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The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights; and
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from Trade and Investment, Regional Infrastructure and Services NSW for its work on energy and water, and from Allens Arthur Robinson for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

Energy + Water Consumers' Advocacy Program

This Program was established at PIAC as the Utilities Consumers' Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- Park and Village Service;
- Ethnic Communities Council NSW;
- Rural and remote consumers;
- Retirement Villages Residents Association;
- the Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

Introduction

PIAC welcomes the opportunity to provide comment on the Australian Energy Regulator's (AER) preliminary *Framework and approach paper for Ausgrid, Endeavour Energy and Essential Energy* (F&A paper), for the regulatory control period from 1 July 2014 to 30 June 2019. PIAC's comments focus on the mechanism to be used to regulate standard control services in NSW. PIAC submits that there are three key factors that should be considered when deciding on the appropriate control mechanism. These are:

- the overall outcome that the method of control seeks to achieve;
- the burden of risk for changes in consumption during regulatory periods; and
- the timing and magnitude of price fluctuations within the regulatory control period.

Distribution network service providers (DNSPs) are natural monopolies, due to the amount of infrastructure they require to deliver their services. However, the AER makes some distinctions regarding which aspects of a DNSP's business are to be regulated as monopolies and which will be regulated differently or not at all. Core business functions, including the provision and maintenance of the network, are designated as direct control services and regulated as monopolies. Direct control services are further subdivided into standard control services and alternative control services. Alternative control services are those with a limited number of customers, in particular street lighting (where the customers are local government authorities). Standard control services are those that all, or most, customers use, including poles and wires, customer service and emergency response—the vast majority of DNSP activity. PIAC's comments in this submission relate to the regulation of standard control services only.

The AER has the option to choose either a revenue cap or weighted average price cap (WAPC) as the control mechanism for standard control services. A revenue cap sets the total amount of revenue a DNSP can collect, while a WAPC sets the total weighted average price a DNSP can charge across its four tariff components: peak energy, other energy, fixed charge and capacity charge.

In PIAC's assessment, both control mechanisms have strengths and weaknesses. Having analysed the prospect of either control mechanism to deliver the best results for consumers, PIAC contends that a revenue cap is more likely to deliver favourable outcomes in the key considerations outlined above. However, if a method can be found to deliver the same outcomes through a WAPC, PIAC would also consider supporting such an approach.

Limiting cost-recovery to the efficient level

PIAC takes the view that the aim of DNSP regulation should be to keep prices as low as possible for consumers. Residential consumers, especially those on low or fixed incomes, cannot be expected to absorb network costs above efficient levels, given these costs constitute up to 57% of residential electricity bills in NSW.[1] For this reason, PIAC supports the AER's position that in deciding which control mechanism to adopt, the AER should consider whether that mechanism 'provides DNSPs with an opportunity to recover efficient costs, while limiting revenue recovery

[1] For consumers in the Essential Energy distribution area. Independent Pricing and Regulatory Tribunal, *Changes in regulated electricity retail prices from 1 July 2012 – Final report*, 2012, 10.

above such costs'.[2] PIAC also holds the view that DNSP costs are largely fixed and determined by peak demand, with sales volume having only a minimal impact.

PIAC considers that the risk of revenue recovery above efficient levels is more significant under a WAPC than a revenue cap. In the F&A paper, the AER notes that Victorian DNSPs recovered revenue 8.28% above efficient levels over the 2006-2010 regulatory control period through WAPC regulation. This meant that the burden on Victorian consumers was $568 million higher than should have been the case.[3] Over recovery under a WAPC occurs when sales volumes increase above forecasts. The value of the WAPC is calculated by dividing the total cost of providing network services by the forecast volume to be carried by the network. This means that when sales increase above the original forecast—but total cost increases are insignificant or at least increase at a lower rate—DNSPs are able to recover costs above the efficient level. A WAPC therefore provides an undesirable or perverse incentive on DNSPs to underestimate their projected sales. This risk is heightened by the complexity of forecasting demand accurately. The F&A paper states that 'while the AER rigorously assesses the forecasts proposed by the DNSPs, the AER is concerned with the overall accuracy of volume forecasts'.[4] A revenue cap removes this perverse incentive, because DNSPs are given a total amount of revenue that they can recover, set at the level required to run their networks at efficient costs.

It should also be noted that under a WAPC, prices for all five years of a regulatory control period are set at one time. Due to the nature of forecasting, the risks of inaccurate forecasts increase for each year after the time the forecasts were made. Inaccurate forecasts under a WAPC can also result in large fluctuations between regulatory control periods. This issue is discussed in more detail below.

The burden of risk for changes in consumption during regulatory periods

A revenue cap and WAPC control mechanism pose different risks for DNSPs and consumers when the volume of total demand is changing within a regulatory control period. Under a WAPC, networks carry the risk of a decline in volume, because they are not able to increase their overall price cap to maintain revenue in light of declining sales. At the same time, consumers carry the risk associated with increasing sales. This is because increasing sales, particularly of one component of the WAPC, give DNSPs an opportunity to reweight the price cap towards that service and recover revenue above efficient costs.

Under a revenue cap, consumers bear the risk of a reduction in overall demand. When overall revenue is capped but volume is falling, DNSPs are able to increase prices in order to reach their revenue cap despite a lower level of sales. Conversely, if volumes increase, DNSPs are constrained in their ability to immediately increase prices in response to increased demand, and must wait until the cap is re-calculated at the end of each year (see below).

Ideally, the risk associated with a decrease in volume should not be borne by consumers. However, PIAC considers that the negative effect of consumers bearing this risk under a revenue cap must be weighed against that of over-recovery by DNSPs above efficient levels under a

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2 AER, *Framework and approach paper: Ausgrid, Endeavour Energy and Essential Energy–Regulatory control period commencing 1 July 2014 (Preliminary positions),* 2012, 54.

3 Ibid 55.

4 Ibid.

WAPC. The risk of this occurring under a WAPC is further heightened due to the need to make longer-range forecasts covering a whole five-year period and the challenge of doing so accurately.

Price stability

The frequency and magnitude of price fluctuations differ under a revenue cap versus a WAPC control mechanism. Under a revenue cap, yearly adjustments are made based on whether revenue in the previous year has been over or under recovered (known as the 'over or under account'). The over or under account is then incorporated into the following year's cap, meaning total revenue remains capped over the whole of the regulatory control period. While these adjustments present potential price fluctuations for consumers, PIAC, like the AER, considers that these could be effectively moderated by introducing tolerance limits for the adjustment in any one year.[5] PIAC also notes that yearly price adjustments are a regular feature of standard contracts in NSW, and changes in network are part of these price movements.

The two control mechanisms also create different fluctuations when volumes are decreasing. Under a revenue cap, volume forecasts are updated annually, in order to calculate the price of a single unit of consumption. Where volumes are decreasing, prices under a revenue cap are slowly adjusted upwards each year. In contrast, under a WAPC, prices are set for five years at the beginning of each regulatory period. While this provides price stability within each regulatory period, if consumption volumes decrease over a number of years, all necessary adjustments will be made in one hit at the start of the next regulatory control period.

PIAC submits that vulnerable consumers are better served by smaller price adjustments that more accurately reflect real-time costs. If demand forecasts are reassessed annually, consumers are more likely to pay closer to the efficient cost of delivering network services and not face five years worth of adjustment for forecast inaccuracy at the start of the next regulatory control period. More gradual price movements also allow consumers to make measured adjustments to consumption in other areas when necessary, rather than being forced to make dramatic cuts at the start of a regulatory control period.

Conclusion

Vulnerable consumers on low and fixed incomes cannot be expected to absorb more than efficient network costs as part of paying for the essential service of electricity. PIAC therefore submits that the control mechanism for standard control services should limit the potential for DNSPs to recover revenue above efficient costs. In addition, the control mechanism should facilitate gradual price adjustments, rather than large jumps between periods. PIAC considers that these are both characteristics of revenue cap regulation. However, if the same outcomes can be achieved through a WAPC approach, PIAC remains open to the possibility of such an arrangement being adopted in NSW.

PIAC also notes that there are risks to consumers under both approaches. Under a revenue cap, consumers bear the risk of increasing prices if demand falls. Under a WAPC, there is the risk of DNSPs over-recovering costs above efficient levels, due to tariff reweighting, particularly when demand grows above forecast levels. Because forecasts for a whole five-year period are made at the start of a price determination utilising a WAPC approach, PIAC believes that the risk of cost over-recovery outweighs those of increasing prices under a revenue cap.

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5 Ibid 60.

Facilitating the best outcomes for consumers will necessitate a thorough analysis of all costs and forecasts proposed by DNSPs so that NSW consumers only face the efficient costs of running an electricity network. It is PIAC's strong view that the AER generally, and the team working on the NSW Network price determination process specifically, must be suitably resourced to undertake this important task.