

Energy in Western Australia Conference 2012

‘Balancing Competing Interests’

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“The Latest on the Economic Regulation Front and Other Musings”

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Introduction

Thank you to the organisers – AIE and the PUO – for the opportunity to again present to this important conference with its very appropriate theme – particularly for an economic regulator – ‘Balancing Competing Interests’. There are indeed many different, and often competing, interests in energy markets.

In my talk last year I used as a text a quotation from the late Frank Devine:

“Politics is for the sceptical consideration of wise men and the eager embrace of rent seekers.”

It is always a relevant warning in public policy discussions but I have two new texts that will serve as themes for my talk this year.

The first comes from former PM Gough Whitlam (although a similar quote has been attributed to Paul Keating):

“The punters know that the horse named Morality rarely gets past the post, whereas the nag named Self-interest always runs a good race”.

Self-interest features prominently in competing interests in the energy industry.

The second comes from the late philosopher and economist Ludwig von Mises who wrote in 1949:

“In a totalitarian system, social competition manifests itself in the endeavours of people to court the favour of those in power. In the market economy, competition manifests itself in the fact that the sellers must outdo one another by offering better or cheaper goods and services, and that the buyers must outdo one another by offering higher prices”.

In judging “competing interests” it is often useful to compare which interests are willing to take their chances in the market place compared to those looking to promote their interests by encouraging those in power to interfere in the market place. It is also a relevant question about which approach is more likely to benefit consumers!

In the next twenty minutes or so I will comment on the ERA's interests, and then comment on the activity of the ERA since the last conference, particularly in the context of balancing competing interests – in particular I will touch on: recent appeals to the Australian Competition Tribunal (the federal appeals body for gas access arrangements) by ATCO and DBP, the report on Synergy, the decision on Western Power, and finally, our annual report to the Minister on the WEM and the implications for the role of the Public Utilities Office (PUO).

In Whose Interest?

Economic regulation has always had as its core focus the long term interests of consumers. The ERA's current purpose as spelt out in our current Strategic Plan is "To ensure consumers receive quality services for a reasonable price".

In the WA Electricity Networks Access Code, the Code Objective has a focus on economic efficiency. The National Electricity Objective (NEO) and the National Gas Objective (NGO) also both have a focus on economic efficiency "for the long term interests of consumers".

The recently released Stage Two Report (Report) by the panel conducting a "Review of the Limited Merits Review Regime" (Yarrow, Egan and Tamblyn) interestingly suggests that there may have been too little attention to the long term interests of consumers in past merits reviews. They have recommended that the NEO and the NGO should be changed to strengthen this focus on the long term interests of consumers – specifically they recommend the words:

"promote efficient investment in, and efficient operation and use of, electricity services/natural gas services in ways that best serve the long term interests of consumers..."

This focus on the long term interests of consumers is further emphasised in their first recommendation which says:

*"That it be made clear by a policy statement that the aim of the merits review regime is to achieve **preferable outcomes** from the network regulation framework by ensuring that relevant decisions promote efficiency.....**in ways that best serve the long term interests of consumers.**"* (Emphasis added)

Before I leave that Report, I must refer to a quotation they use from that great philosopher/economist Adam Smith:

"Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it." (Adam Smith, Wealth of Nations, 1776)

It is worth quoting the footnote the Panel attaches to this Adam Smith quotation:

"We refer any reader who is under the misapprehension that making the long-term interests of consumers the touchstone of regulatory decision making is in any way inimical to the ability of reasonably efficient suppliers to earn a decent profit to the

wider views of Smith, who is not known to have ever argued that governments should regulate prices at below cost, even in the face of public clamour to do so. Profit that is transparently earned by improving the welfare of consumers is the most legitimate form of profit, and hence tends to be the least vulnerable to the attentions of those who might be tempted to mandate unduly low prices.”

So in undertaking its work, the ERA does not have a vested or a self interest other than the long term interests of consumers. Our challenge is to use evidenced based assessment and decision making to balance the many competing interests that exist in the energy market to maximise the long term interests of consumers. And to reinforce the footnote just quoted – it is not in the long term interests of consumers for prices to be either too high or too low.

One final comment before moving on. While I have referenced the Report of Yarrow, Egan and Tamblyn regarding the Limited Merits Review, and while I support their focus on economic efficiency and the long term interests of consumers, I would not want this audience to go away thinking the ERA endorses the recommendations of the Report. I don't have time to go into detail here (it is a topic for another day) but the ERA's view is that the Report is flawed particularly in its proposed solutions. As my colleague Stephen King commented in a blog this week:

“The Report correctly identifies some of the problems with the current review system, but the recommended solution will make these problems worse.”

Stephen was commenting in a personal capacity, however, for a variety of reasons it is a view consistent with that of the ERA.

Appeals to the Australian Competition Tribunal (ACT)

This year has seen the conclusion of two appeals to the ACT against decisions of the ERA with respect to WA Gas Networks (ATCO) and the Dampier to Bunbury pipeline (DBP). There were a number of grounds for appeal although the most substantive issue in both appeals was with respect to the WACC or rate of return. To a very large extent, the Tribunal upheld the ERA's decisions.

In recent decisions we have changed the way the ERA determines the debt risk premium (the amount a service provider is allowed above the risk free rate to attract debt funds). We did this because our view was that the traditional approach used by regulators was no longer appropriate (for a variety of reasons it was out of date and did not provide an accurate reflection of the current cost of funds). In particular, in the view of the ERA, it led to a cost of funds allowance that was too high. Our bond yield approach (determined after public consultation) is about accurately reflecting the debt costs of an efficient firm to avoid prices being higher than necessary. It is evidence based because it reflects actual bonds in the marketplace.

Although challenged by providers in appeals to the Australian Competition Tribunal, the ERA's bond yield approach was accepted by the Tribunal albeit with some fine tuning of the calculation of the average debt risk premium. This new approach of the ERA is not about favouring consumers over producers or vice versa but about getting the balance right based on the best available information.

Similarly, based on our observations of what was happening in the market place (that the average debt to maturity for providers was five years) in the case of our DBP decision we based our estimate of the risk free rate on 5 year Commonwealth bonds (previously the risk free rate had been based on ten year bonds). This approach was also challenged by DBP but upheld by the ACT. Again it was about getting the balance right based on the best available information.

Although not directly related to these two appeals, I want to make comment with respect to the risk free rate (a component of both the cost of debt and the cost of equity and therefore the overall rate of return). Some providers have suggested that the risk free rate, which is at historically low levels, is artificially low and therefore not an accurate reflection of either the cost of debt or the cost of equity and therefore leads to understated WACCs or rates of return. The argument is that as a result of the GFC there has been a flight to quality, and therefore to government bonds, lowering the risk free rate. If rates are too low, there is potential for underinvestment, and this would not be in the long term interests of consumers.

Two responses.

First, regulated monopoly assets, which are what the ERA regulates, are also quality assets with solid, and generally predictable, cash flows. The evidence looked at by the ERA indicates that as a result of lower risk free rates, the cost of debt and equity to regulated infrastructure assets has come down. In the case of debt this evidence is based on observed yields. In the case of equities, we note that trading multiples implied by share prices suggest asset values greater than the regulated asset base implying the market discount rate is below the regulated WACC.

Second, research by the ERA Secretariat for our recent Western Power Final Decision (see Appendix 9 of that decision), suggests that the best predictor of the future risk free rate over the life of an access arrangement (5 years) is the 20 day average prior to the decision. The 20 day average is a better predictor than either a one year average or a five year average (and one year is better than five). This research was based around historical analysis following significant fluctuations in the stock market. This indicates to the ERA that if we were to adopt the suggestions of some providers that we should look at longer periods for averaging (which currently would lead to higher risk free rates) then we would be biasing the cost of debt and equity upwards which would not be in the long term interests of consumers.

Inevitably, at some time in the future, risk free rates will start to rise. It will be interesting to see whether providers will still advocate for a longer averaging period when rates are rising!

Synergy Inquiry Report

In early June this year we released our final report into Synergy's Costs and Electricity Tariffs. We were asked by the State Treasurer to report on the efficiency of costs incurred by Synergy and the efficient level of tariffs that would be consistent with removing any subsidies currently provided to Synergy (that is, what would cost reflective tariffs look like). I hope you have all read it! Consistent with the theme of balancing conflicting interest, I want to comment on just two aspects of our report – what are efficient generation costs and what is driving increased costs.

The ERA assessed Synergy's power procurement contracts and whether Synergy optimises those contracts in meeting its electricity demand. With the exception of the Replacement Vesting Contract, the ERA was satisfied that a competitive and prudent process had been followed by Synergy.

However, in estimating Synergy's efficient wholesale electricity costs, the ERA did not use Synergy's actual costs. This was because in a competitive market a new entrant into the market would not have been bound by existing contracts or constraints and, in the ERA's view, could have entered the market with a lower wholesale electricity cost. In a competitive market it is the lowest cost operator that will determine the price. If an existing player has higher costs, then it will have to adjust to the market price. This is how a market works and why investors in the market require a rate of return (profit) consistent with the risks.

In determining the efficient wholesale electricity costs the ERA was required to balance the interests of Synergy with those of consumers, and in the absence of a competitive market, make a judgement based on the best information available.

As an aside, I suspect this is why the adjustment for the cost of carbon in the retail electricity price as approved by the State Government was slightly higher than suggested by the ERA report. The Government was working on Synergy's actual costs whereas our report was based on efficient costs.

I want to briefly touch on the reasons behind recent increases in electricity costs. Our report notes that there are a range of causes:

- For ten years between 1997 and 2007 there had been no increase in retail tariffs (inflation increased by 47 per cent over this period);
- There had been higher fuel costs – both gas and coal;
- Significant increases in network costs following a lengthy period of underinvestment in the network to the extent safety issues were very real;
- Increases in the subsidy paid to Horizon Power financed through the levy on distribution charges; and
- Increases in costs of complying with a range of Commonwealth and State Governments' renewable energy policies.

A major contributor has been the network charges. In the view of the ERA, this has not been about "gold plating" although we would agree with Ray Challen of the PUO who it is reported recently told the ABC:

"While there may be investment that is ill-planned, ill-timed or not at minimum cost, it probably reflects processes and efficiency of the business, rather than a deliberate intent to make investments for the purpose of earning greater revenue".

The issue has more to do with the underinvestment that has occurred over the last decade or more. The good news is that, in our view, there is no need for those increases to continue and this is reflected in our recent decision on Western Power which sees, on average, annual real increases of less than one percent over the next five years based on forecast energy usage at the time of the decision.

Considerable media attention has focussed on the affordability of recent increases in electricity costs. Here again there is a need to balance competing interests. Efficient use of energy is encouraged by cost reflective prices, but such prices may cause real hardship for some on low incomes. But, is subsidising power costs the best way to deal with the affordability problem particularly given the challenge of targeting subsidies only to those in need. I note the recent *Cost of Living Report 2012* released by WACOSS. The WACOSS report suggests that utility costs make up around 3.7% of a low income working family household budget. However, as the WACOSS Report makes clear the real challenge to cost of living comes from increases in housing costs (rent) which now makes up 28 % of the same family's budget.

Western Power Final Decision

The ERA's Final Decision on Western Power's Access Arrangement for the next five years was released on September 5, 2012. Based on forecast energy usage at the time of the decision, the approved target revenue for the five year period results in real increases of average tariffs of less than one percent per year for the next five years. This compares with the average increases proposed by Western Power following the draft decision of 10.3 per cent real each year (and compared to 16.4 per cent real p.a. in the initial proposal). The most significant reason for the difference was the rate of return allowed by the ERA was significantly less than proposed by Western Power. I want to comment on two particular aspects of the decision.

Many of you will be aware that the ERA has been critical of Western Power's planning, design, governance and efficiency of investment expenditure in previous access arrangements. Indeed in our decision on the second Access Arrangement, as a result of an ex post assessment of capital expenditure undertaken in the first Access Arrangement, the ERA excluded an amount of \$261m from the capital base. Western Power has acknowledged that in response to this decision it "sharpened" its focus on initiatives to improve strategic planning, delivery and compliance processes. (I suspect that it is this issue that is behind the comments by Ray Challen that I mentioned earlier.)

In our Final Decision, the ERA (based in part on our technical consultant's advice) acknowledges the improvements in processes that have been achieved by Western Power, although notes concerns that there are still areas of weakness, particularly in relation to risk management and asset information, which could lead to inefficient investment decisions.

I believe this ability to undertake ex post assessments is important in balancing the interests of Western Power and consumers by ensuring there are adequate incentives to encourage only efficient investment by Western Power. This is not an option available to the Australian Energy Regulator in the National Electricity Market, although I note there is a proposed draft rule change which would allow an ex post review of capital expenditure that exceeded the provider's forecast capital expenditure at the time of the access arrangement decision.

The second area I want to comment on is the conflict of interest facing the State Government as both a policy maker representing the interests of all West Australians and as a shareholder

of Western Power. I suspect that those public servants whose responsibility it is to worry about State finances might have a different view about our Final Decision compared to those whose focus of concern is electricity consumers!

2011 Annual WEM Report and the Role of the PUO

The ERA's annual report to the Minister for Energy was publically released on May 14, 2012. While the Report found the market was working reasonably well, it did note that it was always intended that the market would continue to evolve and there are a number of issues regarding the WEM's operation that require resolution. At that time, these included: potential merger of Synergy and Verve, substantial excess capacity procured under the RCM, increasing costs of DSM, effectiveness of the outage planning process, impact of increasing intermittent generation, and the potential for a conflict of interest under current market governance arrangements.

I don't propose to discuss these now, but in the context of this Conference's overall theme "*Balancing Competing Interests*", here is where those conflicting interests come to the fore. In this Report and in previous Reports the ERA has called for greater involvement in these decisions about changes to the WEM by the then Office of Energy (now Public Utilities Office). We have consistently suggested the need for an open, transparent process where all competing interests have the opportunity to put their views but, at the end of that process, decisions are made in the long term interests of consumers.

In my talk last year I gave the following warning:

"It is often the case that attempts to interfere in the market are done more in response to vested interests (political or producer) rather than the interests of consumers. The benefits of intervention are often highly concentrated among a relatively small, but vocal group who have much to gain by lobbying the Government to intervene in the market place while the costs, which in aggregate are more often than not greater, are more widely dispersed over the population at large who do not have the same incentive to lobby as hard."

I concluded my talk last year by observing:

"We need an open, transparent and very consultative process. An open forum led by an "independent" Office of Energy where all participants can express their views and have those views tested is, in the ERA's view, more likely to:

- ensure that the focus remains on the long term interests of consumers;
- ensure we give priority to those issues most likely to deliver benefits to consumers;
- and
- ensure that the benefits of future reforms exceed the costs.

The work requires a high level of expertise, the agenda is growing and the "rent seekers" need to be kept at bay – a properly focussed and resourced Office of Energy should be a priority for the State Government."

Well, we now have a new Public Utilities Office. This talk was prepared before Ray's presentation on behalf of the PUO yesterday. There is a big agenda for the PUO and many

conflicting interests to be dealt with including the conflict of the Government as both policy maker and shareholder. In my view the long term interests of consumers should be the guiding objective for the PUO. I wish Ray and his team well.

Thank you for listening.