Not so smooth: assessing outcome against intent

Submission in response to the AEMC consultation paper on the DNSP proposed revenue smoothing derogation

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1. Introduction

The Public Interest Advocacy Centre (PIAC) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) consultation paper on the participant derogation submitted by the NSW and ACT Distribution Network Service Providers (DNSPs).

PIAC's view is that the AEMC's assessment criteria do not support a proper assessment of the derogation proposal. The focus should be to consider whether the likely effect of the proposed derogation would be to increase the amount of revenue that could be recovered in the absence of the derogation, regardless of the final adjustment amount. The assessment criteria currently proposed by the AEMC are too narrow to properly accommodate consideration of consumer impacts and efficiency.

Once more appropriate criteria are set, stakeholders and the AEMC can undertake a more useful analysis of the proposal and get a better picture of the impact on consumers.

For example, under the existing rules, DNSPs may be unable to recover allowed revenue in full. If there were a revenue shortfall, there would be two fairly direct effects. First, network prices for 2019 and the following period could be lower than otherwise. In other words, network prices would move towards efficient cost. This could be expected to result in slightly higher demand than otherwise. Second, despite a possible increase in volumes, returns to network owners could be lower than otherwise. Depending on the timing of an AEMC decision on the derogation proposal, the realised sales prices for the remaining networks could be lower than otherwise.

In this context, if the objective is to reduce volatility the best method to achieve this may be to retain the existing rules, including the remaining side constraints and the customer impact principle. Networks would then be able to set prices at a level consistent with both their regulatory obligations and commercial interests. The AER would also retain its current flexibility under the Rules to smooth prices from year to year. An alternative method would be to consider the adequacy of the existing suite of side constraints. If price volatility risk is of concern, the existing suite of side constraints may need to be both extended and tightened.

This submission discusses this proposition and presents alternative options and assessment parameters that, in PIAC's view, more comprehensively take into account the National Electricity Objective.

The lead author of this submission is Senior Policy Officer, Tina Jelenic. The submission is informed by research PIAC commissioned from Sapere Research Group.[1]

1.1 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.

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1 Sapere Research Group, 'Review of AEMC consultation on proposed participant derogation: DNSP revenue smoothing', 9 December 2016.

PIAC was established in 1982. It has maintained an active role in advocating for the interests of energy consumers since its inception.

PIAC's Energy + Water Consumers' Advocacy Program (EWCAP) represents the interests of low-income and other residential consumers of electricity, gas and water in New South Wales. EWCAP is funded by NSW Trade and Investment.

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;
- Ethnic Communities Council of NSW;
- Salvation Army Eastern Australia Conference;
- St Vincent de Paul Society of NSW;
- Physical Disability Council NSW;
- Tenants Union of NSW;
- Financial Rights Legal Centre; and
- Good Shepherd Microfinance.

2. Background

On 24 March 2016, the AER applied to the Full Federal Court for judicial review of the Australian Competition Tribunal's decisions in relation to the AER's network determinations. The Full Federal Court has heard the matter and has reserved its judgement until 2017. It is likely to be some time before the appeal process is resolved, and this may involve a remittal to the Tribunal to consider the matter before it goes back to the AER.

The National Electricity Rules do not explicitly allow the DNSPs to recover or forgo a portion of any higher or lower revenues arising from the remade 2015 Determinations in the following regulatory control period. Significant price shocks may occur if the DNSPs recover revenue adjustments in the current regulatory control period only. That is, if the adjustment amount (whether positive or negative) is fully incorporated into network prices in the final year of the current regulatory control period, this has the potential to lead to significant positive or negative price shock for NSW network customers.

The proposed solution is a derogation from the Rules to require the AER to:

1. Determine a subsequent adjustment amount for each DNSP; and
2. Include any revenue increment or decrement arising from the adjustment amount in the subsequent determination through an adjustment to the building block costs (and hence allowed revenues) for the first regulatory year of the subsequent regulatory control period.

Once the adjustment amount is carried over into the subsequent regulatory period, it then gets incorporated into the X or smoothing factors for each subsequent year of the regulatory period. In this way, the portion of the adjustment amount carried over can be smoothed over the entire five year regulatory period. The derogation would expire at the end of the subsequent regulatory period.

2.1 Issues and gaps in the AEMC paper

It is important to note that regulated price caps set price ceilings but not price floors. The AEMC's consultation paper appears to conflate the two. Importantly, movements in price caps also do not necessarily result in volatility. To the extent that price volatility could contribute to investment and usage decisions intended to avoid price volatility, a decision by networks to set their prices equal to price ceilings may not be in their long term commercial interests.

Additionally, the AEMC paper does not consider the operation of relevant side constraints. Side constraints reflect the principle there is a trade-off between allowing networks to set prices within overall revenue caps and limiting price increases. They are designed to provide a limit on tariff movements between periods in addition to overall revenue caps. They may also limit the transfer of unrecovered revenue from one multi-year price control period to the subsequent price control period.

It is unclear from the paper whether the AEMC has tested if existing side constraints, such as the tariff class level constraints, would be binding once the adjustment amount exceeds a certain value. If they would not and there is a risk the rate of price increase is undesirable in terms of the NEO, this raises the question of whether the remaining side constraints are useful. A full rule change to make side constraints effective could be a better means of addressing the issue arising from a potentially large positive adjustment amount.

We also note that the consumer impact principle is not cited in the AEMC paper. This principle was intended as a replacement for the side constraints removed by the AEMC in 2014 in its decision on distribution network pricing arrangements.

Recommendation 1

That the AEMC distinguish between revenue caps and realistic price changes for networks, noting previous high rates of price change led to changes to the regulatory framework and an AER Final Determination that resulted in substantial reductions in price caps in the following regulatory period.

Recommendation 2

The AEMC should test whether side constraints bind and consider the adequacy of the suite of existing side constraints (scope and point at which they bind).

2.2 Effect on consumer decisions

Over the last few years, as maximum electricity demand in NSW significantly decreased, NSW networks continued to invest in substantial new network capacity on the basis of forecast strong maximum demand growth. For example, in Ausgrid's case, maximum demand reduced by around 15-20 per cent between 2010 and 2015, while at the same time the regulated asset base increased by 75 per cent (additions of $7,075 million). As a result, the overall level of electricity prices is higher than the efficient level. This creates distortions, in the form of suppressed demand for network services.

Overall allowed network prices significantly exceed efficient costs. This reflects the significant excess capacity, for which the efficient cost is zero. Price increases led to changes to Chapter 6 of the NER and the AER's Better Regulation Package. They also contributed to changes in consumer behaviour in the form of reducing or bypassing network services to minimise the impact of price rises. This suggests at some point price increases are not commercially feasible, regardless of whether they are permitted under the NER.

There is growing evidence that the price elasticity of electricity demand is higher than it was a decade ago. This partly reflects the very large increase in retail prices which is beyond the level of increase typically assumed in price elasticity studies. It also reflects the falling cost of network alternatives. Price elasticity is likely to continue to increase as the cost of electricity storage falls.

The AEMC's consultation paper appears to assume that investment and usage distortions are symmetrical whether the adjustment is positive or negative. However, demand elasticity is not linear and so distortions are more likely to be an issue if the adjustment amount is positive and networks decide to pass this through to the maximum extent possible under side constraints. For example, networks may be constrained from fully recovering any positive adjustment amount in the final year of the present price control period, while they would be obliged to pass on any negative adjustment in the same period.

The issue in terms of the NEO is not primarily about the profile of the recovery of the adjustment amount, it is the adjustment amount itself (to the extent this is converted to higher network tariffs) that would result in higher rates of network by-pass than otherwise.

Recommendation 3

The AEMC should assess whether the main effect of the derogation would be to increase potential network revenues from a positive adjustment amount:

a) Taking into account realistic constraints on network price increases

b) The likelihood consumers could make similar network by-pass investment and usage decisions whether the adjustment amount is recovered under one or six years.

Recommendation 4

The AEMC should undertake further consideration of the interaction between the network pricing objective and the pricing principles, notably:

a) The customer impacts principle

b) Reducing the existing gap between overall prices and overall efficient costs, due to the presence of excess network capacity

c) Retaining commercial incentives on networks to promote economic efficiency with respect to its direct control services

d) Consider whether regulated network service providers should be allowed to recover more than the efficient cost of providing direct control services, and a rate of return that exceeds the regulatory and commercial risks involved in providing the services to which that price or charge relates.

2.3 Effect on price of capital

Despite the uncertainty over the 2015 determinations, the NSW government recently sold 50.4 percent of Ausgrid for a price that implied a market value well in excess of the value of the Regulated Asset Base. This indicates a strong investor appetite for NSW distribution assets. It would appear that the uncertainty over how much of the adjustment amount could be recovered did not appear to reduce investor appetite and the substantial price premium paid.

Notably, the Electricity Price Guarantee requires the winning bidder for NSW distribution and transmission networks to guarantee that 2018-19 revenues are lower than 2013-14 revenues. However, seeing as the 2013-14 revenues were very high it is very unlikely adjustment amounts would breach the Electricity Price Guarantee.

Recommendation 5

Referring to the recent sale of Ausgrid, the AEMC should consider whether the risk of under-recovery of the adjustment amount is liable to raise capital costs for networks

2.4 Effect on AER's discretion

The AEMC Issues Paper queries whether revenue smoothing under the AER's Post Tax Revenue Model should be further prescribed in the rules, as proposed by the derogation. This part of the derogation appears to try to reduce the AER's level of discretion over price smoothing.

A possible ground for diverging from the normal smoothing rules in the present case is that the present smoothing rules use the weighted average cost of capital to compensate for the time value of money from revenue shortfalls. This could be seen as overly generous to the networks to the extent that the main effect of the derogation is to increase the total amount of revenue recovered. An argument could also be made that the networks are merely funding a timing difference and so smoothing should merely compensate the cost of debt financing, not equity financing.

This suggests that variations to the current method for revenue smoothing should only be adopted if it the AEMC considers there are grounds for reducing compensation for the time value of money, given the particular circumstances. Otherwise, there appears to be no benefit in terms of the NEO from moving away from the existing revenue smoothing arrangements and flexibility around their application by the AER.

Recommendation 6

The AEMC should only consider adopting temporary rules that prescribe variances to the method for revenue smoothing normally adopted by the AER if it considers there are grounds for reducing compensation for the time value of money, given the particular circumstances.