

**Submission  
No 36**

## **INQUIRY INTO LEASING OF ELECTRICITY INFRASTRUCTURE**

**Organisation:** Commercial Economics Consulting

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## ***Inquiry into the leasing of electricity infrastructure***

*Commercial Economics Consulting*

### ***About Us***

Commercial Economics Consulting (ComEcCon) provides economic advisory services with a strong commercial focus to the energy sector and long life infrastructure businesses such as water services, port and rail businesses. These services include microeconomic analysis, business case development and project review, expert witness, modelling, and advice on regulatory and competition issues.

ComEcCon works with clients through-out Australia and has extensive experience in Australia's energy markets (NEM, SWIS and NTEM), particularly, electricity networks.

### ***Structure of submission***

ComEcCon's submission to the inquiry is as follows:

- an overall response to the Legislative Council's terms of reference
- a targeted response to terms of reference of interest to ComEcCon, and
- a summary of our experience and credentials.

### ***Overall response***

We support the privatisation of NSW's electricity infrastructure through the sale of long-term leases. From our perspective, the privatisation of electricity infrastructure providing an essential service to NSW represents an important and critical final step of microeconomic reform of essential facilities, which commenced in the mid-1990s.

It is a crucial step as it provides the opportunity to improve outcomes to end users who consume electricity network services as an essential input into their own private and business activities. By outcomes we refer to the overarching policy objective for Australia's east coast electricity market, namely the National Electricity Objective (NEO):

*"...promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –*

*(a) price, quality, safety, reliability and security of supply of electricity; and*

*(b) the reliability, safety and security of the national electricity system."*

Since 2005, the NSW electricity networks contributions to achieving the NEO can be largely characterised as a series of stepped increases in electricity network prices, which effectively occurred as a function of the economic regulatory regime providing regulated network prices to achieve state government determined network planning requirements, service reliability and quality standards. While it can be argued that with the application of new planning requirements and service standards the current government owned business may be able to lower network prices, there is nevertheless

substantial merit in privatisation of electricity network assets to inject new thinking and approaches in:

- making transparent the separation between regulatory and licence obligations and business ownership and management
- the management of peak electricity requirements as electricity consumption declines
- enhanced capital management practices for infrastructure assets which is crucial for capital intensive industries
- greater flexibility in managing a static and aging workforce, and
- providing enhanced customer centric services in the face of rapid technological change and associated energy supply options available to end customers.

By accepting a value now for NSW electricity infrastructure, NSW people, as equity owners, cap their risk exposure to likely future earnings volatility from NSW electricity infrastructure given the known changes in technology and potential for competition. Moreover, the Commonwealth Government's asset recycling initiative provides a one off payment for undertaking such reform, which represents a substantial 'free' carry to NSW.

In our view, ensuring that a privatisation program is successful depends on how the government approaches:

- setting objectives for the privatisation, for example the interrelationship between:
  - maximisation of sale proceeds
  - increasing competition
  - improving consumer outcomes

- defining public or social objectives that the privatised entity must address, i.e treatment of universal service obligations (obligation to connect & fair and equitable access), delivery of cross-subsidies, treatment of specific stakeholder cohorts (employees, specific customer groups), and
- ensuring that the privatised entity, particularly businesses such as NSW electricity infrastructure, are subject to effective licence, behavioural and economic regulation (access / price regulation).

On balance we believe that the proposed leasing of NSW electricity infrastructure has adequately addressed these questions.

***The likely implications of the transactions on electricity network pricing, given experience in other states,***

As highlighted by recent research<sup>1</sup>, post 1995 privatisation Victorian electricity prices did not materially increase, and a comparative study of typical electricity network bills between Victorian, NSW and Queensland found that between 1996 and 2013:<sup>2</sup>

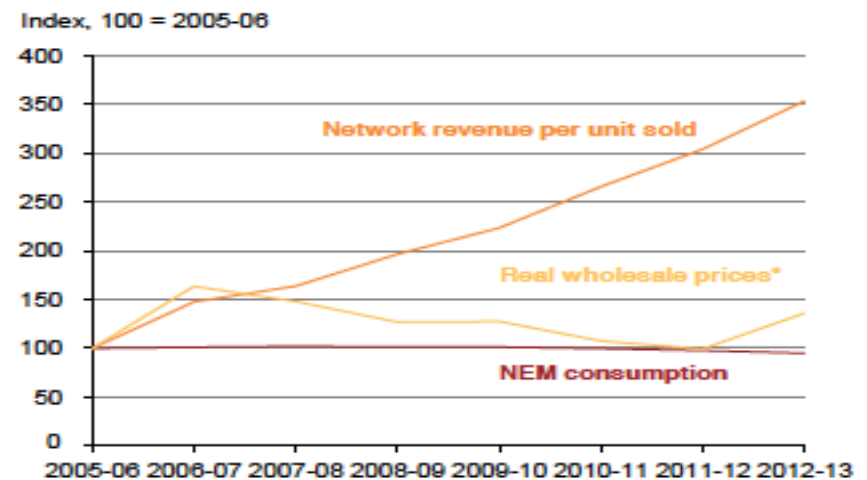
- Victorian privatised network bills increased by 62%
- NSW government owned network bills increased by 212%, and
- Queensland government owned network bills increased by 285%.

Emphatically proving causality is extremely difficult, what is clear from a policy perspective is that privatisation did not result in excessive price increases. From our professional experience from this period we observed that since privatisation the Victorian and South Australian network businesses displayed superior capital management capabilities. For capital-intensive businesses this remains an incredibly important element in ensuring that network services are delivered at least cost.

Since 2005-06 electricity network prices have dramatically risen as shown in figure 1 (price increases measured as network revenue per unit sold). These network revenue increases coincided with:

- a change of economic regulator to the national Australian Energy Regulator (AER)
- a series of reliability and quality of supply events, predominately in Queensland, resulting in legislated increases in network planning, and service standards, and
- the run up of the investment boom in the resources industry.

**Figure 1 – NEM electricity consumption, wholesale electricity prices, network revenue per unit<sup>3</sup>**



Past experience can provide a guide to where prices are likely to be post privatisation. Another guide is to examine regulatory and market dynamics.

<sup>1</sup> Grattan Institute (23 March 2015 <http://grattan.edu.au/news/ignore-the-scare-campaign-about-privatisation/>) and cited Ernst and Young Report.

<sup>2</sup> These are nominal increases.

<sup>3</sup> Grattan Institute 2013, Shock to the system: dealing with falling electricity demand, page 12.

The AER's final decisions for NSW's electricity infrastructure set down revenue requirements that will:

- lower prices by 1% in 2015-16 and then provide stable prices to 2018 for TransGrid
- lower prices by 5.3% in 2015-16 and then provide stable prices to 2019 for Endeavour Energy, and
- lower prices 8% in 2015-16 and then provide stable prices to 2019 for AusGrid.

In the absence of a 'black swan' event, it is difficult to foresee economic drivers that would alter the future trend of stable network prices.

Moreover, policy makers should be assured that given ongoing regulation by the AER there will remain significant scrutiny of privatised network businesses proposed revenue and price proposals. In particular, the AER's recent final determinations on revenues for NSW electricity networks made substantial reductions to proposed operating and capital expenditure forecasts on the basis that the businesses should be providing network services at much lower costs when compared to their peers. Over time this is likely to place further downward pressure on network prices.

In addition, in the next 5-10 years the privatised electricity businesses operating and pricing practices will need to deal with the real and emerging threats of:

- Customer empowerment and potential partial by-pass of the network. This opportunity has emerged as a result of increasing energy efficiency, distributed solar PV, and

increasing likelihood of affordable distributed energy storage.

- Competition from emerging new energy business models.

The short-term risk of network price increases that policy makers need to be attuned to relate to the regulatory solutions to reform current network prices to address the 'death spiral' challenge facing the industry.<sup>4</sup> In short, the economic regulatory regime will continue to set network prices based on revenue requirements by reference to a network's efficient total cost function. So where annual electricity consumption declines the average per customer revenue will increase even where network total cost function remain constant.

We note that the AER and the Australian Energy Market Commission (AEMC) have regulatory review programmes focused on this issue.

*Privatisations of electricity networks in Victoria and South Australia did not result in significant, unjustifiable, and unexpected network price increases. The robustness and stability of the ongoing economic regulatory regime, and emerging trends in electricity consumption provide strong risk mitigates to keep downward pressure on future network prices.*

<sup>4</sup> Simshauser and Nelson, June 2012, The Energy Market Death Spiral – Rethinking Customer Hardship.

**The likely impact of the transactions on customers, including on access to and exit from the network,**

In buying the lease, the lease owner accepts the legal obligations of the existing businesses. The legal obligations, as per the *Electricity Supply Act 1995*, and the National Electricity Law (NEL), provide a comprehensive and well-understood framework providing:

- fair and equitable access to retailers
- obligations to connect customers, including distributed generation, and
- obligations with regard to the commercial arrangements between customers and retailers, including strong customer protections.

The privatised networks, subject to the legal and business structure implemented, will have obligations through the *Corporations Act*, *Work Health and Safety Act*, and the *Fair Work Act*. Accordingly, with these protections we consider there to be minimal risks of the transactions negatively impacting on customers.

For policy makers, it is important to note that the AER's *Better Regulation Program* (introduced in late 2012) provides guidance to network businesses to improve customer engagement. The AER's initiative emerged from concerns that network businesses needed to improve engagement with customers as the basis for improving customer outcomes.

Given that this is an explicit element within the AER's regulatory oversight of the network businesses it provides assurance to policy makers that customers' interests will be explicitly considered. Moreover, it does highlight that the electricity network sector needs

to improve customer management generally. We would see any prospective owner seeing improved customer engagement as an opportunity to improve the financial returns from their investment and as such, as a critical success factor.

A potential risk to network businesses, regardless of ownership, would be where the evolution of distributed electricity technology allows for safe, secure and reliable permanent or semi-permanent exit from the network. We expect that this is likely to be an increasing risk over the next ten years as emerging technological solutions are commercialised.

The legal and economic regulatory regime would need to be adaptable to be able to protect customers, limit financial damage from asset stranding, and provide a 'level playing field' within what would be a competitive market for distribution services. Despite the uncertainty of these developments we would expect that the energy market's legal and regulatory institutions would provide sufficient leadership to ensure reform of the regulatory frameworks to adapt to such change as the basis for achieving the NEO.

In addition, the NSW Government's proposed consumer protection requirements, notably the ultimate ownership of assets through an active independent statutory authority and clear legal oversight of prices and service standards by independent regulators, represent a 'belt and braces' approach to protecting customers.

*We do not see there being materially risks to customers from the transactions. The existing legal and regulatory framework provides adequate and robust protections for customers.*

**The responsibilities of any lessee(s) to maintain, improve and replace infrastructure and the ownership of infrastructure that has been upgraded or replaced,**

The setting of responsibilities for lessee(s) on maintaining, improving and replacing infrastructure can be adequately managed through the conditions of sale of the lease. The market for buying leases on government owned assets is relatively mature (since the 1980s), and provides numerous examples of mechanisms to effectively manage any requirements that the NSW Government may require as part of the sale.

At a strategic level, arrangements for guiding lessee(s) responsibilities could consider:

- technical requirements, for example, maintaining, improving and replacing infrastructure according to ‘good industry practices’ consistent with maintaining the service potential of the underlying assets, and
- financial or economic requirements, for example, asset management practices maintain the value of the assets through time (i.e. as per the agreed depreciated replacement cost method set at the time of the sale with a ‘true-up’ at the end of the lease).

These principles would be supported by transparent and detailed policy and guidance associated with maintaining, improving and replacing infrastructure. An example would be setting reliability standards and network planning requirements to meet specific measurable service outcomes.

Importantly, for the transaction to be successful it is important that these requirements are:

- transparently set
- subject to periodic and independent monitoring
- incorporate mechanisms to deal with material unforeseen shocks to technical and financial requirements (black swan events), and
- supported by proposed dispute management mechanisms that allow stakeholders to effectively manage their risks according to a known process.

To date, the information disclosed by the NSW Government on the proposed transactions provides limited high-level guidance on these matters. However, it is expected that sale documentation will provide the detail to allow potential buyers to ‘price’ these requirements, and provide the NSW Parliament and NSW community with information in order to assess the efficacy of these requirements in terms of effective asset management of the electricity infrastructure assets under lease.

If the NSW Government were to require the lessee to provide specific non-economic services then we would expect that these would be transparently identified, subject to periodic review, able to be adjusted for material unforeseen shocks, and funded (up-front or through time). There is a range of ways to incorporate the inclusion of such non-economic requirements into the transaction including:

- making the requirements explicit in the sale process
- providing bidders with the opportunity to include ‘extras’ as part of the proposed bid, and

- only revealing these requirements to short-listed bidders.

The NSW Government's proposes that the Independent Pricing and Regulatory Tribunal (IPART) ensure compliance with licence conditions, safety and reliability standards. IPART's role could be enhanced further to have oversight of forward asset management plans, and have the explicit role of ensuring compliance by the new owners, including the responsibility to undertake audits and investigate material events.

South Australia's Technical Regulator and the Essential Services Commission of South Australia (ESCOSA) carry out a similar role where relevant industry participants are required to annually provide a Safety, Reliability, Maintenance and Technical Management Plan (SRMTMP). From these reports, the independent agencies have the information and the responsibility to ensure assets are being maintained in accordance with agreed requirements. Moreover, the regime has strong public accountability characteristics through the statutory requirements for public reporting of outcomes.

*Any risks associated with asset maintenance, improvement, and replacement can be effectively managed through the setting of clear policy objectives for the technical and financial requirements to be met by the lessee(s) and the NSW Government. The NSW Government would need to detail how these objectives would be met through:*

- *the appointment of independent agencies to oversee the requirements*
- *provision of detail on technical requirements, reliability, safety standards etc*
- *provision of details around how financial / economic value*

*requirements are to be managed*

- *providing the independent agencies with sufficient responsibilities and resources to effectively carry out these responsibilities.*

### **The regulatory framework for electricity distribution and transmission networks and the proposed Electricity Price Commissioner,**

We consider that the maturity of the current licence and economic regulatory regime provides a transparent and consistent framework for the regulation of network businesses. The regulatory framework is robust and provides certainty around outcomes as it:

- is legally based
- provides significant levels of guidance
- has nearly 20 years of precedents on the application of the core elements of the regulatory approval process
- ensures significant levels of external scrutiny of network businesses proposals
- provides access to a known mechanism for appeal, and
- has transparent governance arrangements, including a robust framework to facilitate justifiable changes to the regulatory framework.

As indicated above we do foresee changes in technology and the economics of alternative distribution services to be a risk but in terms of network prices this would represent downward pressure on network prices. We expect that such market changes are likely to also put pressure on the regulatory framework, particularly how





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network prices are set. However, we consider that the energy market's legal and regulatory institutions would provide sufficient leadership to ensure reform of the regulatory frameworks to adapt to such change as the basis for achieving the NEO.

The NSW Government's proposal to appoint a Price Commissioner to review transactions to ensure that there will be no upward pressure on prices as a result of the transactions provides a further safeguard.

*The current licence and regulatory frameworks are robust and provide a high level of certainty on ensuring that the privatised network businesses continue to deliver electricity services in accordance with the NEO.*



## Who is Commercial Economics Consulting

Commercial Economics Consulting (ComEcCon) provides economic advisory services with a strong commercial focus to the energy sector and long life infrastructure businesses such as water services, port and rail businesses. These services include microeconomic analysis, business case development and project review, expert witness statements and analysis, modelling, and advice on commercial, regulatory and competition issues.

ComEcCon also provides boutique management consulting advice to energy and infrastructure businesses across strategy, operations, and IT system strategy and implementation through our extensive network of Associates. Our Associates have extensive experience in Senior Management and Leadership roles in their areas of expertise.

ComEcCon's Principals, James Reynolds and Rob Prydon, provided regulatory and market advice on the following transactions:

- Buy-side Moomba to Adelaide Gas Transmission Pipeline
- Sale of various power stations and long-term energy contracts
- Corporate strategy for vertical integration of government owned generator and electricity retailer
- Valuation of government owned generator Coal Fired Generator as part of JV buy out
- Economic and regulatory advice on Alinta M & A transaction (Babcock and Brown and Singapore Power)
- Sale of Allgas Gas Distribution network to APA
- Purchase of Allgas Gas Distribution network by APA

- Buy-side economic risk report on Bass Link
- Buy-side regulatory due diligence DirectLink and Murray Link (interconnectors)
- Purchase of Abbot Point Coal Terminal leasing process
- Purchase of WestNet below rail infrastructure
- Purchase of DBNGP