GRATTAN Institute

Fix the electricity mess

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The time for electricity price reform is now. On Friday the Council of Australian Governments will discuss reforms to the electricity sector. At the centre of the proposed reforms is the need to change the way electricity is priced by the regulated monopoly businesses that distribute power.

Australians are worried about rising power bills, and COAG must act decisively to make the big changes that would deliver major savings and put the interests of consumers back in front. So far, there has been too much blaming and not enough fixing.

The regulatory structure and processes are broken. They allow electricity distributors to earn bigger profits than are justified by the risks in the business. They are too inflexible to address changing circumstances, such as recent falls in demand. As well, government-owned businesses spend much more than privatised businesses, in part through state government intervention to keep reliability standards unduly high, in part out of inefficiency.

A Grattan Institute report released today, *Putting the customer back in front: how to make electricity cheaper*, documents major flaws in the system and identifies four changes that could save customers around $2.2 billion a year.

First, governments should direct and empower the Australian Energy Market Commission (AEMC) and the Australian Energy Regulator (AER) to implement clear rules about the risk premiums and costs of debt the companies are allowed to use as the basis for charging their customers. It should also hold the AER to account for implementing those rules.

Second, the setting of reliability standards should be transferred from state governments to the AEMC and the AER, to minimise political interference.

Third, state governments should impose standards of corporate governance on the businesses they own to ensure they operate at least as efficiently as those that have been privatised. Otherwise, they should privatise.

Finally, forecasts for capital expenditure should be revised annually to ensure they remain in line with changes in market demand. If demand drops, so should the price of electricity.

The AEMC is the central agency responsible for changes to the regulatory rules. With other bodies, it has proposed rule changes to address a range of flaws. These are headed in the right direction. If the costs of past faults were not so high and the urgency to change not so great, it might be reasonable to sit back and encourage the AEMC and the AER to go ahead and await the results.

However, the history of these agencies has not been good in this area and governments must be more directive now to ensure we get the changes we need. The AER has had considerable power in the past. Even when its own assessment concluded that these businesses had a low risk profile, they set the parameters well above the upper limit of the range in the interest of regulatory stability.

We've had too many reviews. We can't wait another five years to see if adjustments have us heading in the right direction. The evidence is compelling, the savings that should be delivered are substantial. Consumers have a right to expect more action this time around.

Investors need to know how the parameters that will significantly influence the returns for the businesses will be set. Retrospective changes or unpredictable interventions are highly undesirable, and would ultimately rebound through higher risk premiums -- exactly the opposite of what is needed. The changes we propose will reduce the returns the businesses have enjoyed, but they will also provide predictability on how key inputs such as risk premiums and cost of debt allowances are set.

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The ultimate test is the actual returns generated by the businesses. Over time, these should be within reasonable limits of the returns generated by businesses with similar risk exposures. COAG must insist that the current equity risk parameters and allowed cost of debt are set on this basis. Any changes that follow should be monitored in a transparent way and further adjustments made if the profits remain outside the defined range.

This is similar to the way the RBA sets interest rates to keep inflation within reasonable bounds. It would provide predictability for investors, savings to consumers and confidence to both.

A small number of changes could deliver savings of at least $100 on average for every residential customer. This is too much to be left hanging.

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