GRATTAN Institute

Why Australians are getting a raw deal on electricity prices

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If there's logic behind the way Australian energy markets work, at first glance it's hard to fathom. Increases in power bills have previously been justified by our increasing demand. But as energy demand in Australia drops prices continue to rise. This raises numerous questions. Is the type of demand changing? Is there the right type of investment in the network? Are the right energy market mechanisms in place?

In 2012-13, residential electricity prices increased by 14%, continuing a trend of double-digit increases going back to around 2007. This is a clearly a problem for homes and businesses and, therefore, for our political leaders.

The largest component of the price increase has come from costs imposed by the network distribution businesses, and yet these are regulated monopolies. The power to change rests with the regulators and, therefore, with governments. Yet, these monopolies, facing very little price or volume risk, make outsized profits. Why hasn't the government done more to prevent this?

Grattan Institute issued a report in December, 2012: *Putting the customer back in front*: how to make electricity prices cheaper. This report drew four conclusions:

- The allowed profits exceed reasonable levels, given the low level of risk these network distribution businesses face.
- Costs are being incurred to achieve unjustified levels of reliability – our electricity system doesn't need to be as reliable as these business are telling us.
- The process of five-yearly reviews does not reflect the changing dynamics of the industry.
- Government-owned businesses are on average significantly less cost-efficient than their privately-owned counterparts.

The report made four recommendations that have the potential to deliver savings to consumers of around $2.2 billion per year, a saving to the average domestic customer of $100 per year. These are:

- Align allowed equity and debt returns with the risks faced by the businesses.
- Give regulators, rather than state governments, the power to set reliability standards.
- Where governments own the businesses, they should address poor governance or privatise.
- Capital forecasts should be revised in line with changing demand forecasts.

In December, the Council of Australian Governments and the Standing Council on Energy and Resources (SCER) developed and moved to implement an electricity market reform package. This package is intended to strengthen regulation, empower consumers, enhance competition and innovation and balance the network investment interests of owners and consumers.

The Implementation Plan extends over 2013 and 2014 and puts considerable emphasis on strengthening the power and resources of the regulator (the Australian Energy Regulator, or AER).

It seems that expectations now rest heavily on the way the regulator responds to the various changes in its direction, powers and resources.

In March, 2013, the Australian Energy Market Commission – the rule maker – published a report on future electricity price trends. It estimated that nationally, the aggregated distribution network price will increase by 6% annually, from 2013 to 2015. This compares with an 11% increase between 2012 and 2013. These increases are estimated to represent 81% of the increase in residential retail prices.

The key questions now are will these reforms and price reductions be delivered and are they enough?

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There has been criticism that the regulator has been too timid in its prior regulatory decisions and has tended to err on the side of investors. For example, in assessing the appropriate risk premium that businesses could earn, the regulator leaned towards encouraging investment rather than containing costs. The end result has been excessive returns for investors.

It will be important to assess the results of changes by looking at delivered outcomes, and not the actions and processes that are set up. The critical outcome will be the reported profits of the businesses – they should align with the risks faced. Savings of around $400 million per per year could be expected in coming years.

The communiqué from the last meeting of the Standing Council on Energy and Resources contains very little language to suggest it plans to be accountable to consumers for delivering them a better system. The current level of business ownership by state and territory governments and the challenges of delivering outcomes through federal processes would seem to work against what is and should be achievable.

Given the delivered outcomes over the last few years in terms of price increases for consumers and profits for shareholders, we should probably be seeking a much better result than the 6% price rise the Australian Energy Market Commission is estimating.

Although regulation is needed to ensure that companies have incentives to invest, recent decisions have disadvantaged the public. Governments need to take a more pro-active role in ensuring that changes are made and the benefits are delivered. It is time to restore the balance, and we should not be patient.

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