The Electricity Market and Price Rises

Summary and Conclusion

The processes that resulted in the sale of Government's electricity assets and the regulators' decision to approve price increases have not been transparent.

Governments and its regulators have not acted in the public's interest and governments have not satisfactorily explained the need to privatize these vital assets.

The government could have sold its electricity assets and provided some protection against price rises by:

- Imposing conditions on the sale regarding price rises.
- Choosing buyers other than energy businesses such as superannuation funds and non profit organisations.
- Shortening the energy value added chain.
- Improving the transparency of electricity prices

Commentary

NSW electricity prices have risen around 80% in the last 4 years. The following explanation attempts to explain why this has happened.

A major factor has been the passive and acquiescent role of energy regulators. The NSW Independent Pricing and Regulatory Authority Tribunal (IPART), the Australian Energy Regulator (AER), and the Australian Competition and Consumer Commission (ACCC) appear to have incompetently or passively assessed the need for price rises and by so doing, ignored the public interest.

IPART determines prices for utility services (transport, water and electricity etc) based on cost inputs set by the NSW Treasury. These can include dividends, rate of return on assets and ministerial directives. Consequently not all the data provided to IPART to justify price increases is known. Electricity retailers successfully challenged IPART's determination that financing costs were too low. Consequently, IPART increased its 'allowance for financing for electricity generation.' It is not known why IPART agreed to do so.

Based on its generous latitude, IPART has approved billions of dollars in investment to upgrade all sub-stations that form the poles and wires networks of the distribution networks of Transgrid, Ausgrid, Essential Energy and Endeavour Energy. These firms form an oligopoly. This means that price competition will be minimal and price rises more frequent. Thus IPART's claim that it works to optimise market competition and value in the long-term interest of the NSW community, economy and environment is unconvincing.

IPART is not the only regulator that has failed to act in the public interest. In 2010, the Australian Competition and Consumer Commission approved the sale of NSW government's electricity assets to TruEnergy and Origin Energy, giving these firms control of 85 per cent of the NSW market. It justified its decision on the basis that 'continued vigorous competition from existing players, would be likely to preserve competitive tension in the retail markets.'

Vigorous competition did not occur as electricity prices on 13 June 2012 rose18%. ACCC's action is contrary to its stated role to promote competition and protect the rights of consumers especially in markets where competition is less effective. Thus far there appears to be barely any price competition in NSW's electricity market.

The substantial amount of capital needed to fund fixed assets such as plant, equipment and machinery in the generator sector and poles and wires in the network sector creates a high barrier of entry in a mature oligopolistic industry. High fixed costs require significant market share to generate cash to service debt and provide investor dividends. Capturing market share and earning competitive rates of return in this market are major hurdles for new entrants. This makes it a costly and risky venture for other types of energy providers as well.

Competition in an oligopolistic market is more inclined to be price setting than price taking; the reason being that products or services tend to be homogeneous, with scant differentiation between one firm and another. Oligopolistic businesses have very good knowledge of the market, their costs as well as their competitors' costs. On the other hand, consumer knowledge is not as good in determining price, cost and service quality. Consequently, shopping for lower electricity prices is unlikely to deliver much buyer satisfaction.

A lack of transparency also restrains competition. Energy retailers use several suppliers, each with different pricing schemes. Information on the Australian Energy Regulator's web site shows that it is virtually impossible to calculate retailer margins. This information would put more pressure on power companies to price fairly. Yet the Australian Energy Regulator, an independent statutory authority committed to promoting outcomes that are in the long term interests of consumers, tolerates the lack of transparency in pricing regimes. Even though AER considers it important for consumers and other stakeholders to access information easily, little has been done to make this so.

In the 12 June 2012 Sydney Morning article entitled ***High power rates: it's a poles and wires story***, John Pierce, the head of Australian Energy Market Commission (AEMC) was quoted as saying

> *'The thing that has driven price changes, more than anything else has been the rates of return that have been set.'*

The figures below show that high rates of return have been achieved.

Electricity Network Sector Profitability 2010/11

Business	Ausgrid	Endeavour	Origin
Return on Assets (ROA) %	9.1	10.8	18
Return on Equity (ROE) %	17.2	20.5	67

There are several reasons why this is so. As stated earlier, the energy market is oligopolistic in all its 4 sectors that comprise the lengthy value added chain – generator, transmission network i.e. poles and wires, distribution and retail – through which price increases are extended. Just why it is so lengthy and hence costly, has not been explained. Why couldn't it be shortened? What is the value added of each sector? The bottom line is that the 3 firms in the network sector are in a powerful position to force price increases on its customers.

Even so, IPART included the cost of purchasing equipment and machinery with operating costs. The purchase of capital equipment is not an expense; it is the purchase or construction of a non-current asset. It therefore should not result in a price increase as capital expenditures do not directly impact on profitability. Qantas does not increase fares when an airplane is purchased.

The Weekend Australian June 11 – 12, 2011 mentioned a figure of '$33 billion in capital works that would be spent on aging distribution networks that deliver power with most of the spending required in NSW and Queensland'. Financial capital, in the form of equity and/or long term interest bearing debt, should be used to fund these fixed assets and not price increases. Well managed businesses endeavour to match their funding to the life expectancy of the asset being purchased. It would be unlikely for a retail electricity supplier to reduce prices when these assets are paid off. It is therefore unfair, inappropriate and illogical for IPART to allow price increases of electricity services to perpetually fund depreciating fixed assets**.** Operating costs, not fixed assets should be used to determine the cost of electricity generation. But as implied earlier, IPART, it seems has no say in what expenditures are used to justify price increases.

Power companies blamed climate change policies, for the need to upgrade the electricity network to avoid blackouts for the price increase. This explanation is unacceptable as this cost had yet to be incurred.

None of the regulators have acted in the public's interest contrary to their stated mission.

As a result, there are serious questions about the independence of these regulators. They have failed in their obligations to optimise market competition and maintain or increase value in the long-term interest of the NSW community, economy and environment. Financial information has not been released on the grounds of commercial confidentiality.

State governments have failed to keep the public fully informed of the privatisation of the State's monopoly assets in electricity generators, distributors and retail. In addition, they have failed to act or be seen to act in the public interest.

Joe Nagy
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