



Submission to the Special Inquiry into New South Wales Electricity Transactions

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1. Introduction and Context

We refer to a letter from Clair Miller dated 27th May advising that the Hon Brian Tamberlin QC has been appointed as Special Commissioner to inquire into and report on all matters relating to the electricity transactions in New South Wales; involving the sale of the electricity trading rights to Eraring Energy and Delta Electricity's Mount Piper and Wallerawang power stations and the State-owned electricity retailers Energy Australia, Integral Energy and Country Energy. The Energy Users Association of Australia (EUAA) welcomes the opportunity to put forward its views on this to Special Commission.

The EUAA is the national association of energy users in Australia and has over 100 members, including many of the largest energy users in New South Wales (NSW) and in the National Electricity Market (NEM) more broadly. As such, our members had a strong interest in the outcome of the NSW electricity sale process, which could have significantly affected the competitive environment in which they purchase energy. We have taken a strong interest in all past attempts by the former New South Wales Government to sell its electricity assets including the sale process under review here.

We examined the benefits of privatisation of the electricity sector in New South Wales when we commissioned a report in 2008 to model the impacts of optimizing competition through the sale of electricity assets in NSW. The resultant report produced by the consultancy firm Intelligent Energy Systems (IES) found that the optimal outcome would be to break up the State owned generation assets into at least 5 entities prior to sale. The report showed that this would reduce electricity prices in NSW by 26 per cent and in the NEM more broadly by 16 per cent compared to business-as-usual. This confirms that there are significant gains through a sale process that optimizes competition in generation.¹

The original reform agenda that lead to the transactions under review involved the following key aspects:

- The sale of the generation portfolios (gentrader contracts) of the power stations owned by Macquarie Generation, Delta Electricity Western and Delta Electricity Coastal and Eraring Energy.
- The sale of the three electricity retailers Energy Australia, Integral Energy and Country Energy; and
- The sale of seven generation sites at Bamarang, Tomago, Marulan, Bayswater and Mt Piper.

It should be noted that the option of selling the trading rights to the capacity of the NSW generators but retaining the physical assets in Government ownership is an extremely

¹ See IES, *Competitive Market Structure for Electricity and Retail and Generation in NSW* p.7. Copies can be provided on request.

messy outcome and one that is far inferior to an outright sale of the generators. It involves the need to develop contractual and other solutions to a range of issues that do not arise with an outright sale. For energy users, it also involves risks and concerns. In fact, the Owen Review commissioned by the former Government in 2008 to examine the need for sale of state owned electricity assets, clearly felt that it was a second best option and did not favour its use.

Regarding the concerns of energy users about the genetrader model, it may be instructive to reproduce below the findings of an internal paper on it we commissioned in 2009:

Energy users will not be directly affected by the development and negotiation of the contracts. However, users interests could potentially be seriously jeopardised depending on the way, and to whom, the PPAs are sold. The Government of NSW has mixed incentives in this: on the one hand it will maximise proceeds from the sale of the PPAs if it allows one or a few parties to buy all contracts and thereby establish a strangle-hold over the supply of electricity in NSW. On the other hand, doing this is likely to lead to higher electricity prices in NSW, which will be contrary to the Government's state objectives.

The development of PPAs could have a significantly detrimental impact on energy users in NSW. The issues that energy users should be most wary about include:

- *Ensuring that the maximum number of PPAs exists. Preferably there would be PPAs for each unit in each power station, not just the power station in its entirety;*
- *Ensuring that there are restrictions on the sale of the PPAs, in order to reduce market power. This could mean for example ensuring that a buyer of a Mt Piper contract is not also able to buy a Bayswater contract;*
- *Ensuring that the contracts maximise flexible operation so that energy users do not pay higher prices to support inefficient or inflexible work practices;*
- *Ensuring that the contracts have the lowest possible energy and capacity payments;*
- *Restricting buyers that already have a significant retail presence in NSW, from vertically integrating by buying contracts that will closely match their load;*
- *Ensuring that the contract sale process is well designed and executed in order to maximise competition.²*

Last year, the Australian Competition and Consumer Commission (ACCC) examined the impact on the electricity market by the publically declared bidders Origin Energy Limited and AGL Energy Limited if they were to acquire the previously Government owned electricity retailers and the genetrader rights. The ACCC found that the declared

² EUAA, *The privatisation of energy retailers and the sale of generation dispatch rights in New South Wales: what does it mean for energy users?*, internal note.

bidders for the retailers in New South Wales would give them high market shares but preserve competition.³

The final outcome of the sales process was that:

- Origin Energy obtained Integral Energy and Country Energy's customers, and the gen-trader contracts for Eraring and Shoalhaven power stations.
- TRUenergy obtained Energy Australia's customers and the gen-trader rights to Mount Piper and Wallerawang power stations.
- However, the sale of the gen-trader rights for the generation assets of Macquarie Generation and Delta Electricity Coastal's Munmorah, Vales Point B and Colongra power stations did not proceed.

New South Wales electricity users benefit if they are able to purchase efficiently priced and reliable electricity supplies from competitive markets. This is a key 'test' for energy users in terms of the transactions under review, the industry structure that resulted from the transactions and the fact that they did not all proceed to finalisation as originally planned. This is even more pertinent at a time of rapidly escalating power prices in New South Wales. Two major reviews of Australia's energy markets that have reported during the past ten years, the Parer Review and the Energy Reform Implementation Group (ERIG) review, identified market power as a characteristic of Australia's electricity markets.⁴ The EUAA and its members were greatly concerned to ensure that the outcome from the transactions did not result in a concentration of market power and a lessening of competition in NSW.

As mentioned above, electricity consumers in New South Wales (households and businesses) have seen significant electricity price increases over the past two years, with a further 17.3 per cent State average increase in regulated tariffs to occur on 1 July this year.⁵ These price increases are significantly impacted by the costs association with State and Commonwealth environmental initiatives including feed-in tariff schemes, renewable energy schemes and other similar charges. However, the largest contributor to the price increases has come from very large increases in network charges which will have increased by an average of 70 per cent in real terms by 2014 compared to 2009.

1.1. The Current Structure & Ownership of Electricity in NSW

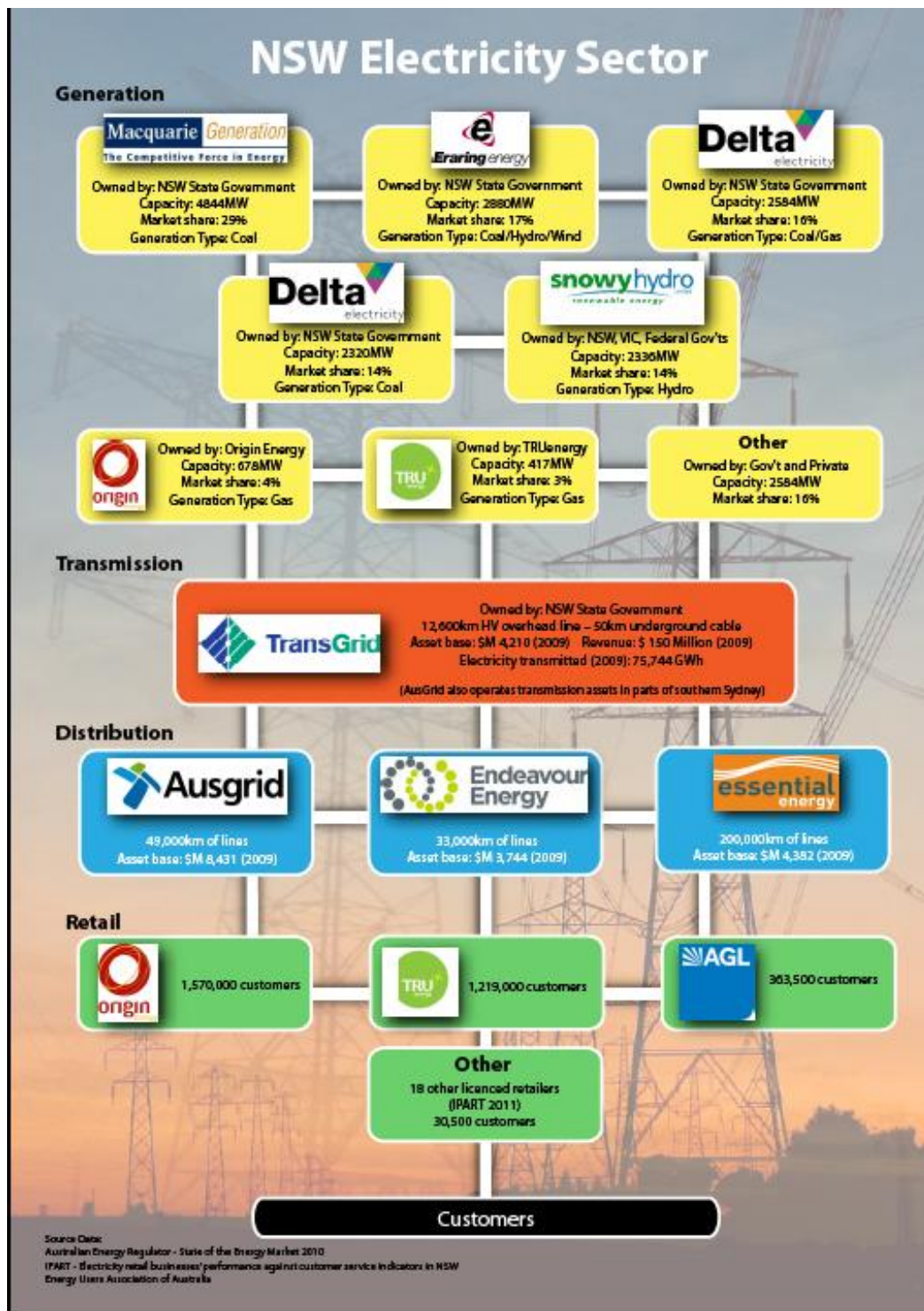
The following diagram (Figure 1) represents the current NSW electricity sector, from generation to end-customers. The majority of NSW electricity generators are owned by the NSW State Government, with coal the main generation type followed by gas and hydro.

³ ACCC News Release, *ACCC clears potential acquisitions under NSW Energy Privatisation*, December 9th 2010.

⁴ Parer, W, *Towards a Truly National and Efficient Energy Market*, 2002 and Energy Reform Implementation Group, *Energy Reform the way forward for Australia*, January 2007

⁵ IPART Fact Sheet *Changes in Regulated Electricity Prices from 1 July 2011*, p 3

Figure 1: NSW Electricity Sector



Electricity transmission in NSW is the responsibility of Transgrid, who operate a system of 12,600km of overhead lines, bringing high voltage electricity from generators, to lower voltage distribution networks.

Distribution of electricity to retailers is provided by AusGrid, Endeavour Energy and Essential Energy, who together operate a network of nearly 300,000km of lines throughout the state.

Electricity is then sold to over 3 million customers through Origin Energy, TRUenergy, AGL and eighteen other licenced retailers.

1.2.Recent Increases in NSW Electricity Prices, Their Impacts & Implications for this Inquiry

Over the past three years, electricity prices in New South Wales have increased at unprecedented levels, with regulated retail electricity prices having increased by around 20 per cent in each year (including the increase that has recently been approved by IPART to apply from 1 July this year). It is well-known that this has placed an unwelcome burden on NSW households and had a significant impact on their cost of living. Information from the Energy & Water Ombudsman also shows that it has led to a large increase in complaints from consumers as well as a spike in hardship issues such as failure to pay bills and disconnections.

These impacts have also been felt by businesses (large and small) with increases in operating costs associated with the use of electricity a consideration for all business users. Some businesses, such as those operating close to the margin, have struggled or failed to cope. Firms exposed to international competition are forced to absorb these cost increases as they are far less likely to be able to pass them on and maintain their competitive position. As these costs keep increasing they do damage to the productivity of the NSW economy, its competitive standing (internationally and inter-state) which will affect investment and jobs.

Because electricity is so pervasive in its use, there are also flow on impacts in terms of the cost of other goods and services consumed by NSW businesses and families. This flows on into the cost of doing business and consumer prices.

Sydney's index of electricity prices has generally remained within a band of plus or minus 10 per cent of the Consumer Price Index (CPI) between September 1980 and August 2008, occasionally diverging to plus or minus 20 per cent. Since late 2008 this band has increased to close to 50 per cent relative to the CPI. The changes in NSW electricity prices relative to the CPI are shown in Figure 2.

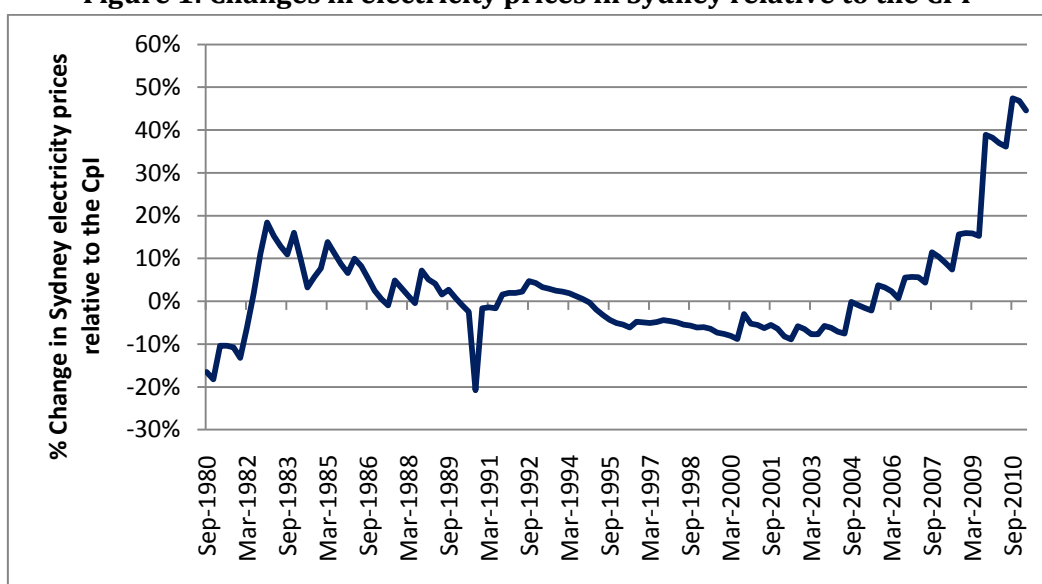
The main driver behind the substantial increases in electricity prices in New South Wales has been increased network charges which comprise distribution and transmission charges. These components make up an average of 50 percent of an electricity bill.⁶ The Terms of Reference state that the Special Commission of Inquiry is to inquire into and report on options for future action that could be undertaken to further the public interest in a competitive electricity sector in New South Wales,

⁶ The TNSPs have not been discussed in the analysis as the report focused on the electricity distributors. However, our expectation is that similar findings would apply to transmission. Distribution charges make up approximately 40% of an electricity users bill, transmission charges make up approximately 10% in NSW.

including options to promote competitive electricity prices and ensure reliability of supply. We suggest in the submission that one of the ways that this can best be furthered – and additional electricity price increases can be mitigated – is through the privatisation of all the Government owned generators in a way that ensures and maintains meaningful competition in the generation segment (which is also important for competition at the retail end); and privatization of the electricity networks in New South Wales along with regulatory reform that ensures they operate with efficient costs and that the benefits of greater efficiency are passed on to electricity consumers.

Figure 2: Changes in electricity prices in Sydney relative to the CPI

Figure 1: Changes in electricity prices in Sydney relative to the CPI⁷



2. EUAA’s Comments on Aspects of the Transactions and Competition Issues

The EUAA was not party to and does not have detailed or specific information about the transactions under review and therefore does not propose to make comment on these aspects of the inquiry’s Terms of Reference (ie Terms of Reference 1 to 3). However, we do have an interest in those Terms of Reference that relate to the costs and benefits of the transactions (4) and that relate to furthering “the public interest in a competitive NSW electricity sector” including 6 and 7 as they have the potential to significantly impact on electricity consumers in New South Wales.

We also comment on:

⁷ Australian Bureau of Statistics 6401.0, Consumer Price Index, Australia. Group, Sub-group and Expenditure Class, Weighted Average of Eight Capital Cities.

- The sale of the State-owned electricity retailers (Term of Reference B).
- The sale of the trading rights of the State-owned Generators (B).
- The cancelled sale of the electricity trading rights of Macquarie Generation and Delta Coastal (E).
- The possible float of some of the assets as part of the sale process (not specifically mentioned in the Terms of Reference but taken under 5).

2.1. The Sale of the Trading Rights of the State-owned Generators

As mentioned earlier, prior to the transactions in question the NSW electricity market was characterised by a concentration of the generation capacity in the hands of the three large Government owned portfolio electricity generators. These businesses were responsible for approximately 78 per cent of the generation capacity in NSW.⁸ Breaking this down further Macquarie Generation possessed approximately a third of the generation capacity; Eraring Energy possessed approximately 18 per cent; and Delta Electricity possessed approximately 27 per cent.⁹ As mentioned, above the original publicly announced intention of the former Government was to sell the trading rights to the physical capacity at Macquarie Generation, Delta Electricity and Eraring Energy as four separate 'gentrader' parcels. The former Government had previously stated that it would sell the trading rights to Macquarie Generation as two gentraders but in the end it stopped short of this.

It is possible to gain a *prima facie* understanding of the level of concentration in generation in the New South Wales electricity industry prior to and after the transactions in question by use of standard concentration analysis used in competition policy. Analysis of the generation ownership structure prior to the sale of the gentrader rights finds that the electricity generation structure was moderately concentrated and that this was maintained after the transactions were completed although there was some modest reduction in concentration.¹⁰ The analysis also indicates that had the Government sold the gentrading rights to the assets owned by Macquarie Generation as two separate parcels to other competitors, then the ownership structure would have become unconcentrated, or more competitive.¹¹ Ultimately, the sale of the trading rights to Macquarie Generation and Delta Electricity's Vales Point B, Munmorah and Colongra power stations did not take place, which in our view would have been beneficial for competition. We also note in this regard that this would be more consistent with the

⁸ Australian Energy Regulator, *State of the Energy Market 2010*, p.24.

⁹ *ibid.*

¹⁰ Analysis involved the use of the Herfindahl-Hirschman Index (HHI) of industry concentration. This involves summing the squared market shares of the owners of the assets. Any number below 1,500 is considered to be a market that is unconcentrated; a number between 1,500 and 2,500 indicates that the market is considered to be moderately concentrated (and potentially of concern in terms of a lack of competition) and any number above 2,500 indicates a market that is highly concentrated. The HHI for New South Wales generation was 2,200 prior to the sale and 1,800 after the sale indicating that the market has moderate concentration before and after the transactions but was less modestly concentrated afterwards.

¹¹ Our analysis indicates an HHI index of 1,400, assuming that these trading rights were not acquired by any of the incumbent holders of the gentrading rights.

findings of the EUAA commissioned study referred to earlier in terms of using the sale of the assets to create competition and allow users access to competitive electricity prices.

It should be noted that this is a *prima facie* analysis and does not take account of complicating factors such as barriers to entry and exit to the New South Wales generation sector, the ability for competitive electricity to be sourced from Queensland generators via interconnected transmission lines and that the former Government's approach of selling the rights to trade the capacity of generating plant that remained in State ownership which introduced a further complication.

2.2. The sale of the State-owned Electricity Retailers

Prior to the transactions, the three Government owned electricity retailers Country Energy, Energy Australia and Integral Energy possessed approximately 80 per cent of the small customer market and up to 90 per cent of the customer bases in their regions of operation.¹² There are 26 holders of electricity retail licenses but not all of these are active and (as mentioned in the previous sentence) the three incumbent Government-owned retailers had a stranglehold on the market prior to the transactions taking place.

Prior to the sale of the retailers, large users had access to six retailers able to meet their electricity needs. Post sale this has reduced to only three.

Retail giants AGL Energy, TRUenergy and Origin Energy were actively competing with the State-owned electricity retailers and were the most successful in increasing their market share out of those firms active in the market¹³; with AGL and Energy Australia dominating the gas retail market.¹⁴ AGL and Origin Energy had registered publically as potential bidders for the government retail businesses on the ACCC website, with AGL eventually withdrawing their interest. EUAA members were concerned that the acquisition of the New South Wales retailers by some of Australia's largest privately owned retailers had the potential to diminish competition in NSW.

Queensland encountered a similar situation whereby there were a number of retailers who had the size to meet the needs of large electricity users, these being Energex, Ergon Energy, Origin Energy, AGL and TRUenergy. In 2005, AGL purchased Ergon Energy and Origin Energy purchased Energex, thus leaving only two large retailers in Queensland.¹⁵ Since these purchases our Queensland members have informed us that they have found it more difficult to source competitive offers from retailers, although the entry of ERM as a new competitor has had some benefits.

¹² Approximately 80% of the small customer market.

¹³ IPART, *Review of Regulated Retail Tariffs and Charges for Electricity 2010 to 2013*, March 2010, p.37

¹⁴ Australian Energy Regulator, *State of the Market Report 2010*, pp 94-95

¹⁵ *Op cit.*, p. 195.

In the post sale environment, two of Australia's largest electricity retailers have obtained the bulk of NSW electricity customers. The ACCC acknowledged that the acquirers of the businesses would have high retail market shares in New South Wales, especially if Origin Energy acquired Integral Energy and Country Energy.¹⁶ The current state of play is that Origin Energy and TRUenergy have acquired the majority of the customer base and face competition from AGL Energy which has a large gas customer base and has publicly stated that it will seek to expand its electricity customer base in the post transaction environment. How it implements this, what degree of price competition emerges and for how long remains an open question. However, in other States EUAA members have found that competition for their load is stronger when new entrants enter the market. The current situation is that the biggest three electricity retailers in Australia have the bulk of the electricity and gas customers in New South Wales but there are some prospects for additional competition.

2.3. Vertical Integration and Barriers to Entry

EUAA members would like to see a competitive electricity market in New South Wales. The National Electricity Market (NEM) – in which New South Wales holds a central position – covers the eastern seaboard and South Australia. The NEM operates as a compulsory pool market where retailers pay electricity generators for their electricity supply and on sell this to their customers. This market has often seen volatile electricity prices especially at times of tight demand and supply conditions.¹⁷

This volatility needs to be carefully managed. To do so, vertically separated generators and retailers can minimise their exposure to volatile spot prices by entering into financial contracts by purchasing futures contracts through the Sydney Futures Exchange (SFE) or forward contracts negotiated bilaterally in the Over-the-Counter (OTC) market. Another way to minimise exposure to spot price fluctuations is through vertical integration and this means has grown in popularity over time, presumably because it is beneficial to retailers and generators compared to the traditional hedges. However, whether it is beneficial to electricity consumers is a different question?

Vertical integration is now a common feature of the NEM and electricity retailers have significant generation assets in their portfolios. This works as a hedge that reduces the incentive to enter into contracts to manage spot price volatility¹⁸ and consequently fewer contracts are offered into the market, reducing liquidity. This makes it more difficult for new participants to enter the market as they are restricted in their ability to minimise their exposure to volatile electricity prices, especially if they do not have a generation portfolio.

¹⁶ ACCC News Release, *ACCC clears potential acquisitions under NSW Energy Privatisation*, December 9th 2010.

¹⁷ Prices on the spot market can vary between a Market Price Cap of \$12,500 per Mega Watt hour and a floor of minus \$1,000 per Mega Watt hour. This can be contrasted to a 'normal' price in the range of say \$30-50 per Mega Watt hour. In fact, the NEM has been described as the most volatile commodity market in the World.

¹⁸ Australian Energy Regulator, *State of the Energy Market 2009*, p.101

The South Australian electricity market is a key example of how vertical integration can impact on the market in a way that is disadvantageous to electricity consumers. AGL Energy acquired South Australia's largest electricity generator, Torrens Island Power Station, after an ACCC approved asset swap with TRUenergy in 2007. Through this acquisition AGL Energy obtained ownership of a third of South Australia's generation capacity. This allowed AGL to move the capacity of the generator in closer alignment with their retail customer loads.¹⁹ This gain, coupled with their dominant share of the customer market, has given AGL the ability to exert upward pressure on spot prices at times of tight demand and supply conditions. The South Australian market is the least liquid market on the SFE averaging about 1 per cent per annum of the total volume of contracts traded on the Exchange and AGL Energy's acquisition has been attributed to the current state of the market in the region, including a 60 per cent increase in generation prices in the two years after the deal. The South Australian retail market has 21 licensed electricity retailers but only four retailers account for 90% of the market²⁰, with three of these retailers possessing generation portfolios.²¹

In the case of New South Wales, if one of the incumbent retailers were to obtain the entire Macquarie Generation portfolio they would possess the largest share of the generation capacity at a level similar to that of AGL in South Australia. This coupled with its trading rights and retail customers would give the incumbent the ability to influence spot prices at times of tight demand and supply. If they also held existing trading rights the problem would be magnified.

Any review of the privatization process and associated recommendations should recognize that significant vertical integration in New South Wales can be a barrier to entry for competitors in the market. Retailers that are not vertically integrated may find it more difficult to enter the market if they must either deal with generators attached to incumbent retailers. There only other option would be to build new capacity in order to compete but this would be a more costly and potentially risky approach. New entrant generators may also struggle to enter the market if they must compete with incumbents that possess market power and are vertically integrated into the retail sector. Our members would not want the South Australian situation described above to occur in NSW should the Inquiry recommend the continuation of the privatisation process, for example.

2.4. Possible float?

The former Labor Government had stated that it would consider a possible float of some of the NSW electricity assets as a means of increasing competition through its sales agenda; and the possibility of combining Integral Energy and the Eraring Energy trading

¹⁹ *Op cit*, p.199.

²⁰ *Op cit*, p.96.

²¹ *Ibid*.

rights for a public float. This did not take place as the former Government sold both to Origin Energy.

If the Commission of Inquiry finds that there is value in a potential float of the unsold assets, this could be a means of adding an element of additional competition into the market. It could also diminish some competition concerns that may emerge in the future; however, this would require a detailed examination by the ACCC. A concern for energy users would be that such an entity would be a take-over target for a large incumbent player resulting in diminished competition. Unless additional measures were put in place (e.g. in Victoria there were special provisions preventing certain types of mergers for a number of years after the privatizations there), the only other means of preventing such transactions would be the *Trade Practices Act*. We would not be confident that this would provide sufficient certainty about the maintenance of competition.

3. Privatisation of the New South Wales Electricity Networks?

Electricity networks comprising of transmission and distribution network service providers (TNSPs & DNSPs respectively) are vital cogs in the electricity sector. TNSPs transport electricity from generators at high voltage and transmit this electricity to substations connected to the transmission system. The substations (owned by the DNSPs) convert this high voltage electricity to low voltage and distribute the electricity to homes and industry. Electricity networks are natural monopolies within their areas of supply. In NEM jurisdictions, the network service providers are owned by State governments in Queensland, New South Wales and Tasmania and are privately owned in Victoria and South Australia. New South Wales has two TNSP (Transgrid, which covers most of the State and Energy Australia, which covers parts of Sydney inside its distribution territory) and three DNSPs Energy Australia, Integral Energy and Country Energy.²²

Electricity network charges comprise around half of the cost of delivering power to end users and these businesses recover the cost of network services from end users and the prices they charge are regulated. The Australian Energy Regulator (AER) assumed responsibility for the economic regulation of the network companies in 2006; prior to this the economic regulation of the New South Wales DNSPs was jurisdictional and performed by the Independent Regulatory and Pricing Tribunal (IPART).²³ The economic regulation of network companies involves the networks submitting five-year price and revenue proposals to the AER who then review the proposals. The AER can make adjustments to the proposal but it must explain why and provide detailed workings of its alternative view. This is very different to the situation that prevailed

²² Now known as Ausgrid, Endeavor Energy and Essential Energy respectively, after the privatisation of the electricity retailers to which they were attached.

²³ The New South Wales TNSP was regulated by the Australian Competition and Consumer Commission (ACCC) prior to 2006.

under IPART and has effectively reversed the onus of proof, placing it on the regulator rather than the monopoly business under regulation. There is increasing concern about this situation from Professor Ross Garnaut, who has found that the electricity networks have the incentive to “gold-plate” and that the appeals process favours the networks;²⁴ and by IPART who have also stated that the appeals process favours the network businesses and identified other failings in the Rules.²⁵

The AER undertook its first review of the New South Wales DNSPs proposals in 2008/09 and granted an 82 per cent nominal increase in allowed revenues over the five years compared to the 30 per cent nominal increase in revenues determined by IPART in the previous five year regulatory period. The increase in revenues resulted in large increases in distribution charges for electricity consumers in New South Wales. At the same time there was a 43 per cent real increase in allowed revenues for the transmission network Transgrid over the same period, compared to the previous decision by the ACCC. A further increase in network charges (transmission and distribution) came from a successful appeal of the AER’s determination on the price and revenue proposals to the Australian Competition Tribunal (ACT), which granted the businesses an additional \$2 billion in revenues and resulted in a further 13 per cent increase in network prices.

During the period when the State bodies regulated the distribution networks, prices for Government owned networks were lower than those of the privately owned networks in Victoria and South Australia. The situation changed dramatically in 2009 with the AER’s first regulatory determination of the NSW network businesses after the State governments decided to voluntarily cede regulatory authority to the AER.²⁶ This is shown in Figure 3.

Figure 3 and those that follow it are based on a report commissioned by the EUAA that compared the performance of all electricity distributors in four NEM jurisdictions (NSW, Victoria, Queensland and South Australia).²⁷ The report was produced because of mounting concerns by energy users about the rapid escalation in network prices and what was causing this. A copy of the report is attached with this submission.

The main reason for the rising network prices is higher capital expenditure which is then reflected in the regulated asset base. Figure 4 shows that by 2014 the regulated asset bases of the Government owned distributors in New South Wales and Queensland will be three times higher per connection than for the privately owned distributors in Victoria and South Australia. Figure 5 compares the capital expenditure of the networks

²⁴ Garnaut, R., *Garnaut Climate Change Review Update: paper 8 transforming the electricity sector*, pp 38-42

²⁵ IPART, *Changes in Regulated Retail Prices from July 1 2011*, p.151.

²⁶ The creation of the AER has provided the benefit to these jurisdictions of higher financial returns, and also the opportunity to attribute responsibility for higher prices to the AER. (EUAA commissioned report Mountain, B., *Australia’s Rising Electricity Prices and Declining Productivity: the contribution of its electricity distributors.*, p.xii.)

²⁷ *Ibid*, p. iv.

on a State by State basis with the New South Wales and Queensland distributors being government owned and the DNSPs in Victoria and South Australia being privately owned.

Figure 3: Indicative average network prices

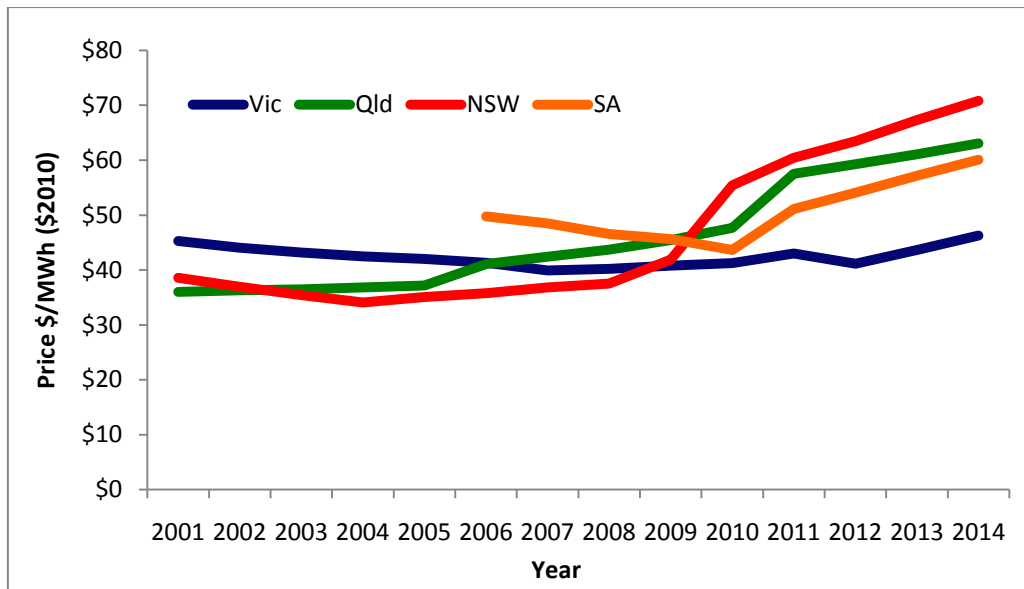


Figure 4: Regulated asset values per connection

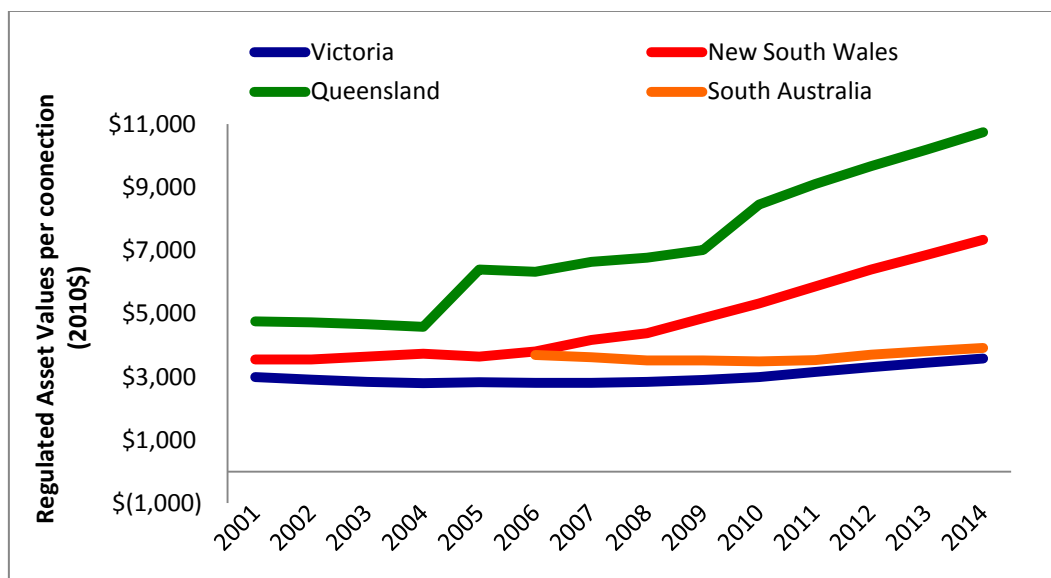
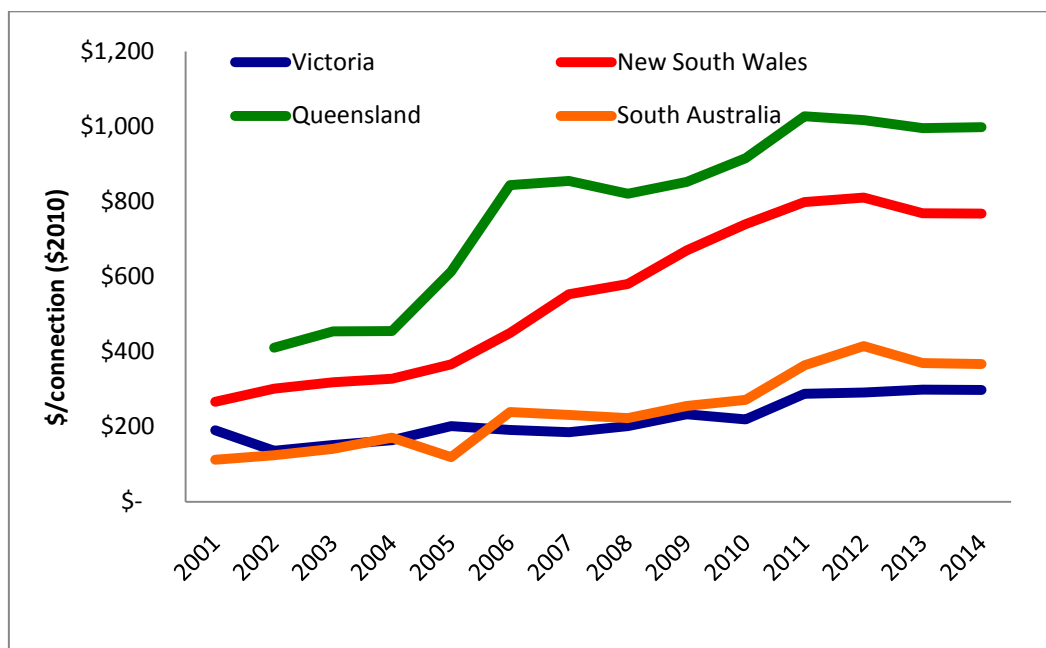


Figure 5: Capital expenditure per connection



The EUAA report referred to earlier has found that the privately owned DNSPs in Victoria and South Australia are far more efficient in their expenditure than the State-owned DNSPs in New South Wales and Queensland and deliver slightly better network performance levels.²⁸ The result is that distribution prices for the State owned networks are unjustifiably higher than for the privately owned distribution networks and the difference is getting bigger.²⁹ These rising costs also explain the decline in productivity of the utility sector, which is the worst performing sector of all twelve industry sectors according to the Australian Bureau of Statistics.³⁰

The AER and the regulated monopoly network providers have said that higher expenditure is needed to cope with rising demand, higher standards, ageing assets and historic underinvestment. The report concludes that these are not the main reasons for the higher expenses, but rather concludes that:

- Growth in demand and customer numbers has been higher in Victoria than in Queensland and New South Wales and yet distributors in Queensland and New South Wales have been allowed to spend four times more per connection than distributors in Victoria.
- The average remaining life of assets in government ownership is 31 years while the assets of privately owned distributors have 22 years of remaining asset life. Despite the fact that government owned distributor assets are newer,

²⁸ A copy of the paper can be provided on request.

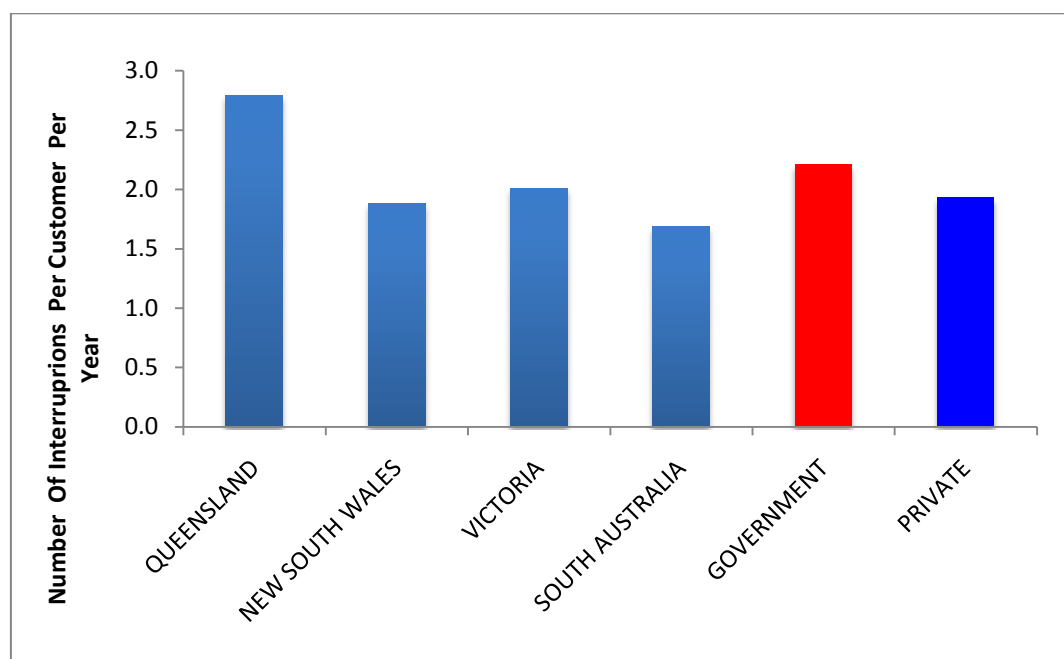
²⁹ Mountain, B., *Australia's Rising Electricity Prices and Declining Productivity: the contribution of its Electricity Distributors*, May 2011, p. iv.

³⁰ *Ibid.*

government owned distributors have been allowed to charge their captive users more than four times as much per connection to replace their newer assets.

- Privately owned distributors in Victoria and South Australia have typically provided slightly higher quality of service than government owned distributors but with significantly less expenditure. It is not clear that higher planning standards for the Government owned distributors is a legitimate explanation for higher expenditure; but it is clear that by comparison the Government owned distributors should be expected to deliver higher quality of supply with less expenditure compared to the privately owned distributors. However, this is not the case. Figure 6 shows the average number of power interruptions in supply state by state and by ownership structure, whilst Figure 7 shows the duration of the power interruptions by state and ownership structure.
- Studies of New South Wales in the 1990s concluded that their distributors were inefficient.³¹ Since that time their expenditure has risen significantly. This suggests the problem has not been historic under-spending.

Figure 6: System average interruption frequency 2001-2009



The research included in the report commissioned by the EUAA shows that rising prices are attributable to rising inefficiency from over investment and inefficient operation, particularly in respect of the government owned distributors, and especially those in NSW. Some of the reasons include:

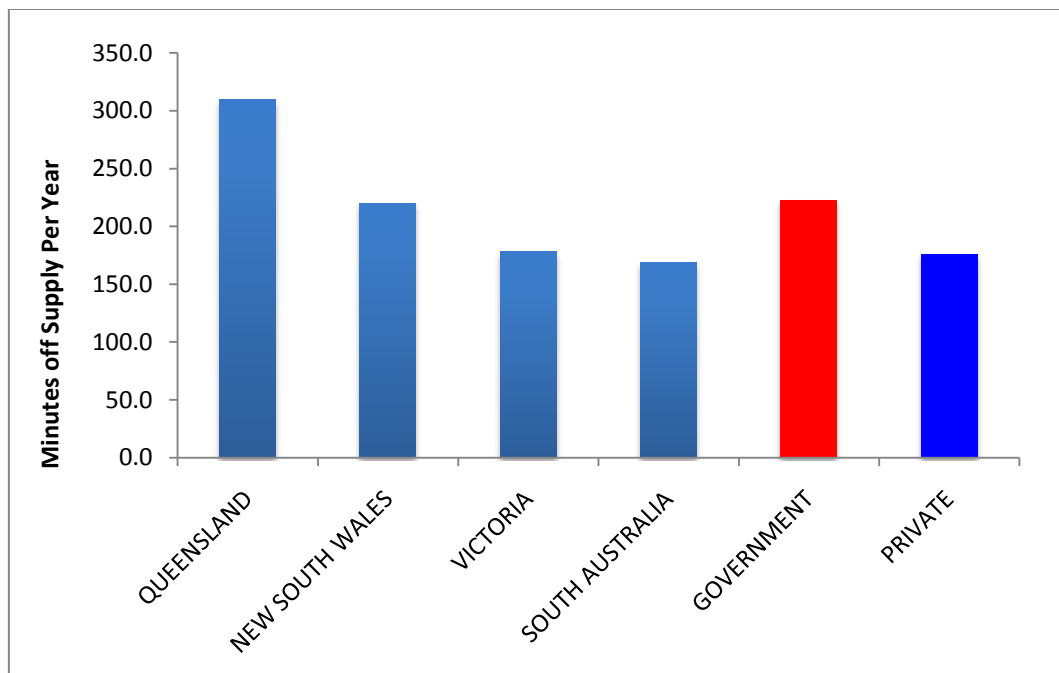
- Distributors have incentives to over invest because they are allowed an excessive rate of return. This is particularly true for the government

³¹ Pierce, J., Price, D. & Rose, D., *The performance of the NSW Electricity Supply Industry*, Reserve Bank of Australia, 1995.

owned distributors since they have access to inexpensive state government funds, and these governments collect the dividends and income taxes on their distributors' profits; and

- The assets of government owned distributors are valued twice as highly per kilometer of network as those of the privately owned distributors.

Figure 7: System average interruption duration 2001-2009



As referenced above, ownership is a significant factor affecting efficiency and privately owned distributors are significantly more efficient than their government owned peers. This suggests that privatisation of the distribution networks has the potential to reduce electricity prices and improve efficiency.³² Privatisation in combination with other measures to help ensure the effective economic regulation of monopoly electricity networks can reduce electricity prices for users in New South Wales and enhance the performance of the NSW economy.

4. Closing Remarks

The outcome of the sale process is that two of Australia's largest energy businesses have obtained the bulk of the retail market in New South Wales, coupled with the rights to trade significant generation capacity. A concern with the outcome is that the electricity industry in NSW is presently in some form of 'half finished' sale process based on a second best hybrid model of physical generation assets in government hands but the rights to trade this capacity partly in private hands and partly in Government hands, a situation unfortunately forced on the former Government. This is a poor outcome and

we cannot see how it could be sustained whilst at the same time ensuring that the NSW electricity market is efficient, can meet the challenges of the future and can deliver benefits to electricity consumers. The EUAA would like to see a competitive electricity market in New South Wales that delivers concomitant electricity prices to all consumers. We would urge the Special Inquiry to consider these matters and seriously consider how to overcome the present suite of problems that have emerged through the partially competed and compromised outcome, including the need for further privatisation of the electricity generators. In this regard, in our view it would be worth supporting options for further disaggregation of the generation assets, including any benefits associated with disaggregating Macquarie Generation's portfolio as originally intended by the former Government and the privatisation of the physical assets (provided this meets the requirement for a more competitive outcome). This would go some way towards mitigating the loss of competition that can result from vertical integration, although we would urge the need to consider options that do not involve vertical integration.

Since 2009 electricity prices in NSW have increased significantly mainly due to large increases in network prices. Analysis commissioned by the EUAA has found that the privately owned DNSPs in Victoria and South Australia have spent less money to deliver better performance outcomes – with higher growth patterns in electricity demand and customer numbers – than the government owned DNSPs. This suggests that the privatisation of the electricity network businesses can deliver lower electricity prices and would not compromise service and reliability. The Special Inquiry should seriously consider the benefits that privatisation of the government owned electricity networks combined with improvements to existing regulation of these monopolies can bring to electricity consumers in New South Wales.