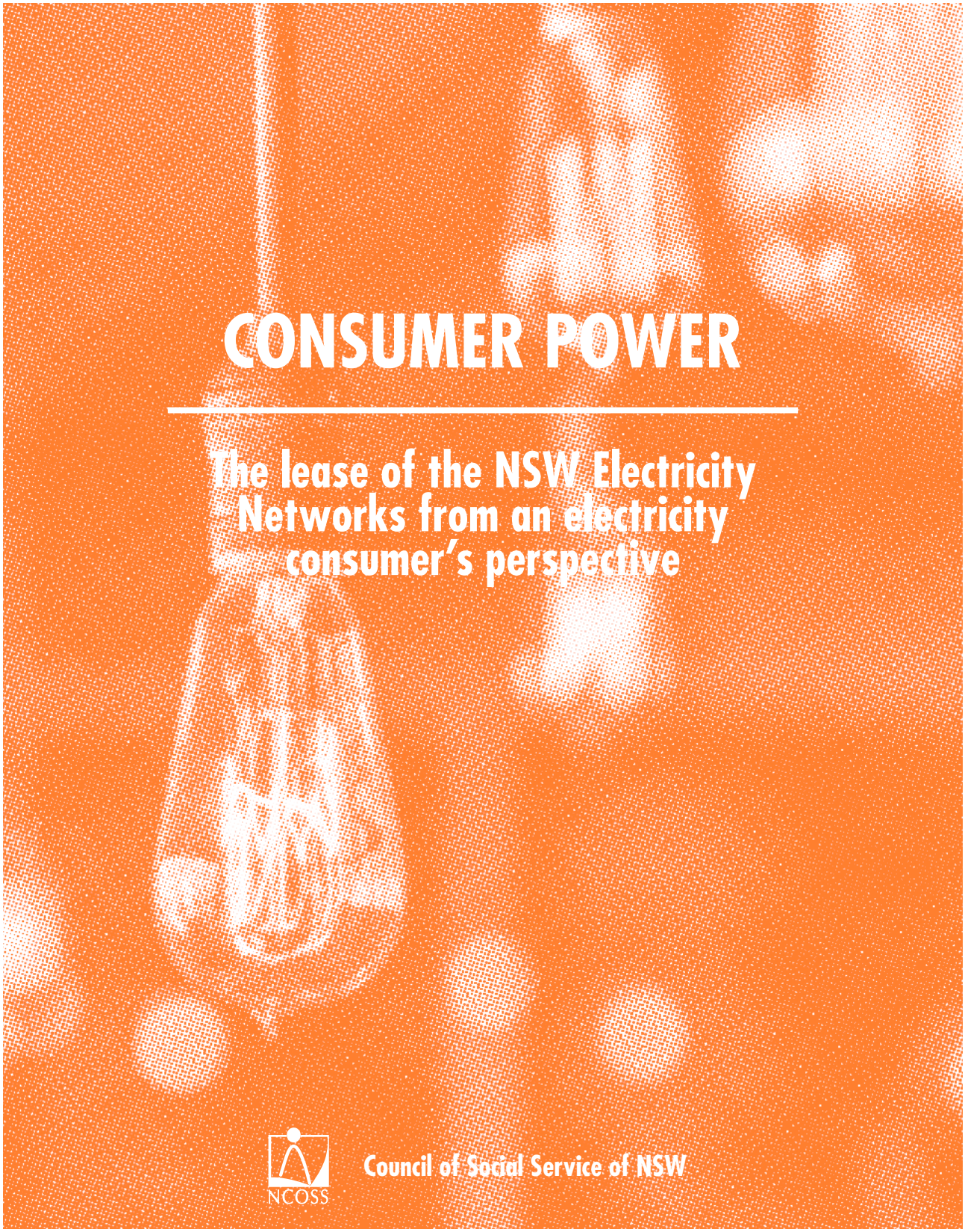

CONSUMER POWER

The lease of the NSW Electricity Networks from an electricity consumer's perspective

Council of Social Service of NSW

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About NCOSS

The Council of Social Service of NSW (NCOSS) is a social justice advocacy organisation and is the peak body for the social and community services sector in New South Wales. We work with our membership, comprising a vast network of service delivery and consumer groups, on behalf of people and communities experiencing poverty and disadvantage in New South Wales.

About the consultants

Bev Hughson has over 30 years of experience in the gas and electricity industry holding various management roles in market research, marketing, wholesale energy trading, retail pricing and retail regulation across the Eastern states. She was closely involved in the restructure of the Victorian gas industry in the 1990s, including the development of the first gas wholesale spot market in Australia and associated gas supply contracts. Bev also provided regulatory advice during the purchase by one of the major non-government retail companies of newly privatised electricity and gas businesses. In 2011 Bev established her own consultancy company, Darach Energy Consulting Services, providing consultancy services to various consumer representative bodies.

Carolyn Hodge is an independent consultant with expertise in energy consumer advocacy. From 2010-2014, Carolyn led the Energy & Water Consumers' Advocacy Program (EWCAP) as Senior Policy Officer for the Public Interest Advocacy Centre (PIAC). This role saw Carolyn play a major role in setting EWCAP's strategic direction to maximise positive outcomes for residential consumers of electricity, gas and water in NSW and more broadly in the context of activities related to the National Energy Market. In 2013, Carolyn managed a CAP-funded project, playing a lead role, in partnership with Bev Hughson, to advocate for residential consumers in the Australian Energy Regulator's Better Regulation Program.

This project was funded by the Consumer Advocacy Panel (www.advocacypanel.com.au) as part of its grants process for consumer advocacy projects and research projects for the benefit of consumers of electricity and natural gas.

The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

Disclaimer:

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EXECUTIVE SUMMARY

The Government is seeking a mandate to partially lease the State's electricity networks at the NSW election in March 2015. It is motivated by the potential to realise some $20 billion dollars in funding for large infrastructure projects that will have benefits for NSW as a whole. While there has been much focus on how the proceeds of the lease will be invested and what new infrastructure will do for the State, less attention has been paid to how the lease will affect NSW electricity consumers specifically. Electricity network charges make up over 50% of the total electricity bill in NSW. This, coupled with the fact that electricity is an essential service on which almost every household in the state relies, means that changes to network ownership arrangements should proceed only after careful analysis, a weighing of costs and benefits, and the development of strategies to manage and mitigate risk.

This Report analyses the proposed partial lease from the point of view of NSW electricity consumers. It does not seek to answer the question of whether the NSW Government should go ahead with the lease, but aims to ensure the best outcomes for consumers whatever the future holds. The Report is based on a strong belief that if the leasing process progresses, it should occur in a considered, transparent manner that provides consumers with all of the facts about how it will work for them and enables them to make informed decisions about whether or not to support it.

Electricity networks across the country are either publicly or privately owned and it is true that the regulatory framework determines the price people pay; and oversees safety, security and reliability outcome, regardless of ownership.

However, the process of privatisation itself, if not managed effectively, can introduce costs that may impact on prices in the future. We need to learn from past privatisation processes; experts in electricity regulation and governance; and consumers themselves to avoid this happening in NSW.

Additionally, the Government's proposal to partially privatise the Electricity Networks raises questions about:

- how businesses will balance public and private interests;
- how networks under public ownership will deliver best outcomes for their consumers;
- whether the Government will retain any obligation to provide capital or guarantee debt;and
- which business and operational risks should be retained by the public and which allocated to the private sector.

Assessing the value of the partial lease proposal will also require an understanding of whether projected and actual cost savings from the amalgamation of distribution businesses under Networks NSW will be eroded.

A push to release funds for new projects or maximise the lease price must not come at the risk of introducing new costs that electricity consumers will be unable to avoid. Should the lease proceed, it will be important that all 'costs of sale,' including any cost impacts on retained assets, such as Essential Energy, are paid for by the lease proceeds and not by electricity consumers.

While this Report does not purport to be an exhaustive list of all matters to be considered, NCOSS hopes it will act as a useful resource to help facilitate positive consumer outcomes and minimise risks

for the State's electricity consumers.

In relation to the proposed leasing of the NSW electricity networks, the key messages of this report are:

1. The lease process must respect the fact that the NSW community are the ultimate owners of the NSW Networks

The report is prefaced on the fact that the NSW community are the ultimate owners of the NSW networks. As such, they should have a more direct say in the future of the networks and, more particularly, in the allocation of the earnings of the network businesses that are returned to their Government.

It is critical that the processes around the lease acknowledge these fundamental facts. That is, the process should reflect the expectations of the people to be informed and to have their say. Similarly, the community that owns the networks should engage in and share the benefits of the lease.

The key messages below all follow from the acknowledgement of this fact.

2. An informed public debate is required

To date, the details about the lease are not adequate for electricity consumers to make informed decisions about whether or not to support the lease. This report highlights a number of areas where more information is needed for this to occur.

3. Risks to electricity consumers should be carefully considered

If the lease is viewed solely as a means to raise revenue for infrastructure projects, there is a risk that the impact of lease conditions, future ownership arrangements and the potential pass through of costs will not be adequately managed. Although it is understood that the regulatory framework will not alter according to ownership, costs generated by previous electricity privatisation transactions are still part of electricity price determinations in the regulatory framework today.

It is important that we learn from past experience to better manage the risk of costs being passed on as a result of transactions and to ensure that efficiencies gained in recent times are not undone by complex ownership structures. Electricity consumers have a right to know that planning for the lease has included careful consideration of potential risks and that strategies to manage these risks have been introduced.

4. Transparency must be maximised

The framework for the lease is currently being developed. At the time of writing, a Scoping Study was being carried out to assist this process. However, it is not clear when or indeed whether, the outcomes of the Scoping Study will be made public.

It is important that electricity consumers know how the Government is managing competing priorities within the lease process. For instance, efforts to maximise the lease price may have consequences for future network prices if they open up the possibility of pass through applications such as those possible under the current regulatory framework.

Regulation of electricity networks is multi-faceted and occurs across state and national jurisdictions. Electricity consumers will want to know that the process for developing theleasing arrangements includes experts in these areas in addition to other expertise. This will help electricity consumers understand the extent to which the impact of proposed ownership structures has been explored and how risks will be managed in the future.

The partial lease is more complex than a full lease or sale. This complexity – and potential responses to it – should be publically discussed. Outlining plans publically in an open and consultative process will allow a range of stakeholders to alert Government to any unintended consequences the partial lease may trigger. Under a staged consultation process, Government will have the capacity to explain to consumers how it has refined its plans to address any unintended negative consequences identified in earlier consultation phases.

There is also a need for a transparent discussion about whether electricity consumers will bear any additional expense in order for the lease to realise long-term value for NSW as a whole. Fostering an informed debate about how the lease may impact electricity consumers will require the Government to demonstrate how it has analysed the costs and benefits related to the lease using solid evidence, and has thoroughly investigated a range of options.

Clear signals that the Government has responded innovatively to lessons learnt from the privatisation of NSW electricity retailers and generation capacity in 2011 will also help allay consumer concerns.

Beyond the importance that transparency has in addressing consumers' concerns, an open process provides reassurance to potential bidders for the leased assets. Buyers will be more willing to invest at a higher price in an asset lease if they believe that political and regulatory risk has been minimised through an open process, stable policy settings and an effective regulatory framework and independent regulator.

5. Show that consumers will be listened to

The NSW Government is seeking a mandate for its proposal to lease 49% of the NSW Networks at the 2015 Election. It is our view that the election is a blunt instrument that cannot adequately gauge people's support for the structure of the lease. Consumers cannot provide support for the lease unless all lease options have been canvassed and featured in an open consultative process that has reached its conclusion.

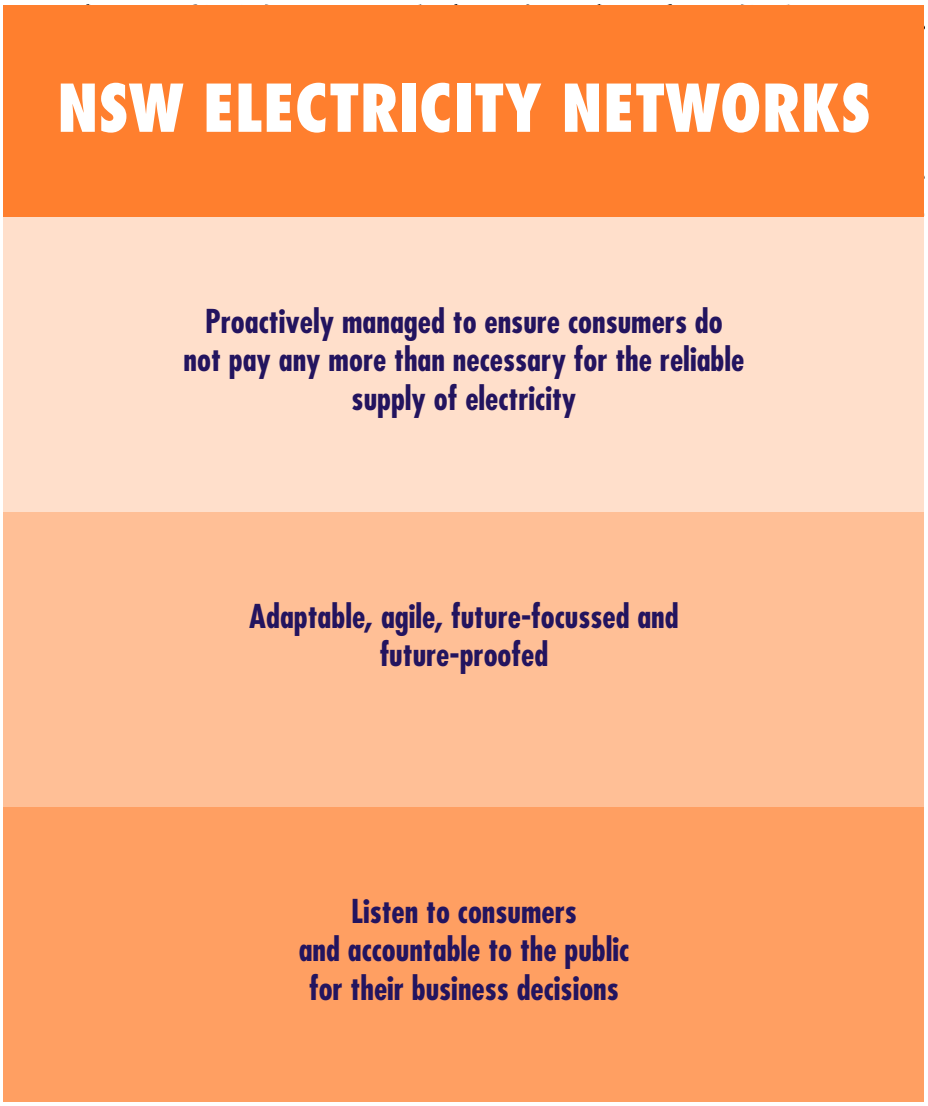
It is important that the timeframes for developing lease arrangements and conditions allow the Government to make key decisions based on sound analysis and a careful weighing of costs and benefits. Consumers will value the ability to see how Government has arrived at its preferred model—even if this model is finalised post election. It is also vital that the Government continues to provide consumers, who currently own these assets, opportunities to be listened to and heard in regard to the structure of the leasing arrangements.

A commitment to continue to gauge consumers' views based on preferred leasing strategies after the election will provide consumers with a greater level of security about their ability to protect their interests as the process develops. Similarly, Government will retain the capacity to respond flexibly as more information comes to hand.

6. Decisions should be informed by a clear vision for the future network

The energy industry is undergoing considerable changes. It will need to adapt even further in response to changes in consumer demand, the emergence of the pro-consumer, the technological developments of the smart grid, and the potential for climate-related policy and environmental changes. However, there is a very real danger that the lease process and lease outcomes become allconsuming, and proceed at the expense of a clear vision about the sort of networks that will best serve electricity consumers in the long-run.

Our vision for a future network – proactive, efficient, agile, future-focused, accountable and responsive to consumers – informs this report, and is represented in the figure below. It is essential that the structure of the lease arrangements does not inhibit the development of a new culture, a new purpose, or even a new design for the network of the future. We believe we should strive for such a network irrespective of the outcome of the next election or whether the lease proceeds.



Summary of recommendations

High level recommendations

Prior to the NSW Election, NCOSS recommends:

1. The NSW Government releases the findings of the Scoping Study and all details about its approach to the lease of the NSW Networks to enable consumers to make an informed decision about whether to support the broad concept of the lease at the ballot box.

2. The NSW Government commits to delivering an ongoing process of meaningful consultation that allows input from consumers and other stakeholders as details about leasing arrangements emerge.

3. The NSW Government commits to a flexible approach that allows it to avoid negative unintended consequences that could arise if strict adherence to a particular model is observed.

4. The NSW Government identifies an ongoing funding stream for all NSW Energy Rebates and communicates this to consumers.

If the privatisation process continues following the NSW Election, NCOSS recommends:

1. The NSW Government introduces an open consultative process on the lease of the NSW Electricity Networks that includes, at its inception, an outline of each step of the process and the timing for opportunities to comment.

2. Prior to any lease going ahead, and as part of the consultation process, the Government provide a consistent flow of detailed information to inform consumers and stakeholders about:

- the lease structures and conditions being considered;
- governance arrangements and accountability under the proposed partial lease model;
- the impacts of new arrangements on the regulatory framework in NSW and for the National Energy Market;
- the principles for prioritising objectives in the lease and a structure to deal with any competing interests; and
- an outline of how potential risks arising from the lease are to be managed, including (but not limited to) the risk of new costs being introduced as a result of the lease and/or the disaggregation of Networks NSW.

The above information should include an analysis of whether proposed arrangements will deliver benefits or detriments to NSW electricity consumers in each distribution supply area.

Chapter recommendations

Chapter 1

Recommendation 1: The NSW Government should assess whether changes to the regulatory framework or the introduction of reserve powers are necessary to elicit responses from networks that are in the public interest where extraordinary circumstances occur.

This assessment should occur prior to the lease and decisions about changes should be made before the networks are offered for lease to maximise transparency.

Any change to the regulatory framework, such as the introduction of reserve powers, should only occur after meaningful public consultation with consumers, industry, regulators and others.

Recommendation 2: The NSW Government should publicly demonstrate whether the actual and projected savings from Networks NSW will be affected positively or negatively by the partial lease.

This demonstration should include an outline of whether cost savings from the aggregated governance of distribution networks under Networks NSW will be lost or reduced as a result of the partial leasing of Endeavour Energy and Ausgrid.

Recommendation 3: The NSW Government should demonstrate publicly and comprehensively how it will maximise efficiency in the portions of the NSW electricity networks that remain under its ownership.

Recommendation 4: Prior to the NSW Election, the NSW Government should outline its proposed governance structure for Essential Energy including an outline of costs driven by any changes to governance structures, or substantive changes to Networks NSW; and any loss of economies of scale that may result if Essential Energy becomes a stand-alone government-owned network.

Recommendation 5: The NSW Government should identify, quantify and develop strategies to manage and mitigate any risks that arise from joint ownership under a partial lease. This information should be made available to consumers prior to any lease structure being finalised.

Chapter 2

Recommendation 6: Prior to the NSW Election, the Government should clarify how the partial lease will change the Government's current role, especially in regard to providing finance to, and guaranteeing debt of electricity networks.

Recommendation 7: Prior to the electricity networks being offered for lease, the NSW Government should review whether the partial lease will necessitate adjustments to statebased policies and legislation. This review should include;

- an analysis of how the network's current status as State-owned corporations will be affected

- a determination of whether the regulatory framework under a new ownership structure, includes sufficient protections to deliver outcomes in the public interest where extra-ordinary circumstances occur; (as per Recommendation 1) and

- an exploration of methods for the Government (as a part owner) to hand any regulatory responsibility it has over to an independent regulator that is sufficiently resourced.

Recommendation 8: Regardless of whether the above review goes ahead, the NSW Government should consult with regulators at state and national levels to investigate whether partial ownership arrangements will have any impact on regulatory oversight and resource requirements to ensure best practice.

Recommendation 9: Prior to the NSW Election, the NSW Government should outline its proposed governance structure for networks under the partial lease proposal.

This outline should include clarification about who will be accountable under the partial lease model for:

- management;
- setting priorities;
- investment and strategy planning;
- capital planning/raising capital;
- remuneration policy;
- setting parameters for representation on the Boards; and
- accountability for financial and operational performance.

Recommendation 10: The NSW Government should develop a transparent process to prioritise and manage objectives where public and private owners have conflicting objectives and/or where conflicting objectives within different areas of Government exist.

Recommendation 11: The NSW Government should commission the Auditor-General to evaluate the lease process and its outcomes once the lease is finalised.

The evaluation criteria should be set now to allow data collection to begin immediately and provide those working on the lease with an understanding of the criteria against which the success of the lease will be judged.

The evaluation should explore the criteria noted in the body of this report.

Chapter 3

Recommendation 12: In order to ensure costs associated with the lease are not passed on to consumers, the NSW Government should:

a) require network businesses to report on potential cost impacts of the lease arrangements being considered so these costs can be minimised and/or recovered in lease transactions.

b) set the lease price inclusive of all transaction-related costs, or agree to hold a proportion of the proceeds in trust for a full regulatory period to be drawn upon in the event of costs arising.

c) seek guidance from the AER about the potential for lease-related costs to be passed through to consumers under current regulatory arrangements and use this information to structure the lease in a way that minimises opportunities for pass throughs or increases to operating expenses.

d) factor the potential for future costs into equations when setting the retention value for the network assets.

e) analyse the costs, benefits and risks (including any potential impacts on electricity

prices) of proposed lease arrangements for each distribution supply area. These analyses should be made public and subject to comment through a public consultation processes prior to any commitment being made; and

f) quarantine any costs generated by the lease of each network as a cost of sale that cannot become a feature of individual businesses' future regulatory proposals.

Recommendation 13: The NSW Government should seek expert, independent advice on the potential for the long-term lease arrangements to impact (either positively or negatively) on any future sale price of the networks and/or the ability to create a competitive tension in any sale that may be considered in the future.

This advice should be informed by an analysis of whether (or how) the Gentrader arrangements affected the sale of the NSW Generators in 2013. The outcomes of this analysis should be used to manage potential risks related to the long-term lease of the NSW Networks.

This advice should be publically released prior to any commitment being made to lease the networks.

Chapter 4

Recommendation 14: The NSW Government should develop a mechanism to ensure consumers receive the full benefit of the 1 per cent discount at both the retail and network pricing levels.

Recommendation 15: To maximise transparency and ensure compliance with the condition to offer a 1 per cent discount on network prices the discount should be applied after the Australian Energy Regulator has approved annual network pricing proposals.

Recommendation 16: The NSW Government should outline an ongoing funding stream for all energy rebates for the post lease period prior to the NSW Election.

Recommendation 17: The NSW Government should replace the flat-rate Low Income Household Rebate and Family Energy Rebate with a percentage-based rebate targeted at low-income earners.

Recommendation 18: The NSW Government should provide additional resources for ongoing energy consumer advocacy to ensure energy consumers are strongly represented in processes related to the lease and in the post-lease environment.

Chapter 5

Recommendation 19: The NSW Government should demonstrate its commitment to a strong, well-resourced and independent regulator both directly, and through its leadership in COAG and the COAG

Energy Council (CEC).

Recommendation 20: Prior to the lease of the network assets, the NSW Government should clarify its statements with respect to constraints on network revenues and pricing.

This includes clarification of how the 1 per cent reduction and the 'CPI cap' will operate within the AER's incentive-based revenue control mechanisms.

Recommendation 21: The NSW Government should work with the AER to determine the most effective way of implementing its tariff-related proposals while maintaining the integrity of the regulatory framework.

Recommendation 22: The NSW Government should avoid further public commitments to network price adjustments or controls, emphasising its confidence in the decisions of the independent regulator and the regulatory process.

Recommendation 23: The NSW Government should urge its networks to submit final revised revenue proposals to the AER that reflect a deeper commitment to achieving operating and capital expenditure efficiencies and to propose a cost of capital that is in line with the AER's Rate of Return Guideline. Controlling growth in the RAB should be a priority given excess capacity.

Recommendation 24: The NSW Government should advise its networks, prior to the lease, that it will be reticent to support merits appeal to the AER's decisions, thereby avoiding the uncertainty that such challenges would create.

Recommendation 25: The NSW Government, prior to the lease, should clarify its approach to ensuring that Government ownership of Essential Energy is not a barrier to Essential Energy achieving the same level of efficiency improvements as that expected from the other networks subject to private investment.

Recommendation 26: Prior to the lease of the distribution network assets, the NSW Government should provide some certainty to both consumers and buyers on its policy positions with respect to the implementation of the new network tariff arrangements and future investment in smart grid technology.

Chapter 6

Recommendation 27: The NSW Government should clarify its position on the national reliability standards and target setting approach prior to the lease of the assets, as this provides certainty to buyers of any future commitments, and comfort to consumers that the Government is focused on best practice outcomes in the regulation of network reliability.

Recommendation 28: The NSW Government should take a leadership role in COAG and CEC to ensure that the extensive and extended investigation into national network reliability standards and targets comes to a satisfactory conclusion for the long-term benefit of electricity consumers in NSW. The certainty and transparency that this provides will reduce risk for consumers and the new investors in the networks businesses alike.

Recommendation 29: The NSW Government should consider the costs and benefits to electricity

consumers in NSW and to potential buyers, of the option of transferring responsibility for the control and measurement of reliability to the AER, following the lease of the assets.

Recommendation 30: If the NSW Government retains responsibility for the control and measurement of reliability, it should investigate the findings of the AEMO study into the value of customer reliability, and take these findings into account when setting the NSW distribution licence conditions in the future.

Recommendation 31: Prior to the lease, the NSW Government should set out its commitment to the independent regulation of network reliability standards after the lease, including the development of short-term "early warning" performance measures as well as the standard reliability measures.

Recommendation 32: Prior to the lease, the NSW Government should transfer to the AER the ongoing responsibility for setting efficient reliability targets and the penalties and rewards under the AER's STPIS arrangements, to ensure better alignment of investment and community willingness to pay.

Recommendation 33: Prior to the lease, the NSW Government should review and rationalise the many existing jurisdictional requirements including licence requirements and multiple reporting requirements regarding reliability. The review should aim to minimise future costs for governments, consumers and the businesses.

Recommendation 34: Before the networks are leased, the NSW Government should ensure that the Board and senior executive team has clear lines of accountability and reporting for reliability performance.

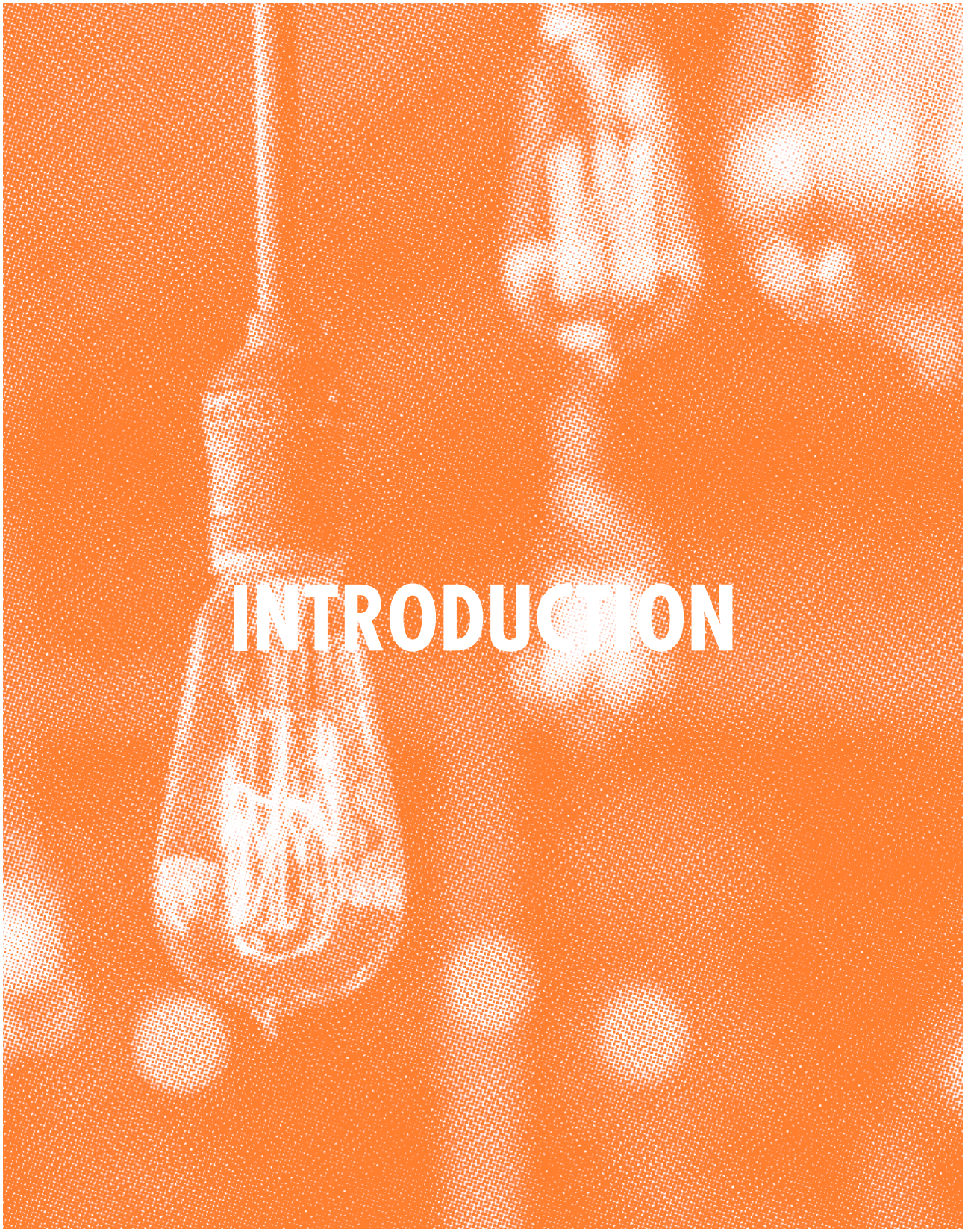
Recommendation 35: Before privatisation (including leasing) occurs, the plethora of regulatory instruments directing, monitoring and reporting safety issues should be reviewed.

Safety, post lease is most efficiently and effectively assured if regulatory gaps are identified and safety related requirements are streamlined, preferably before the leases are granted.

Recommendation 36: The NSW Government should task the ISSC, or similar crossindustry body, with undertaking the consolidation of the various regulatory instruments, and strengthened in terms of its future in monitoring the effectiveness of industry safety codes and guidelines. A clear path, or, "one-stop shop" for the regular public reporting of safety breaches should be put in place prior to leasing the assets.

Recommendation 37: IPART should be made responsible for the management of the Annual Network Performance Reports, rather than the Minister for Resources & Energy, consistent with IPART's role in monitoring licence compliance. IPART should be empowered to take action for breaches of these safety requirements by the networks.

Recommendation 38: Before the networks are leased, the NSW Government should ensure that the Board and senior executive team have clear lines of accountability and reporting for safety performance.


INTRODUCTION

In June 2014 the NSW Government announced its intention to fund large infrastructure projects through the partial lease of the NSW electricity networks. The Government expects the partial lease will realise some $20 billion that will fund a range of infrastructure projects, with benefits to NSW citizens flowing from improved access to better roads, public transport, schools, hospitals, sports and cultural facilities.[1]

At this time, the Government also discussed some of the framework for the lease. For instance, it has committed to maintain majority ownership of the networks.[2] Other conditions it is set to impose include:

- all net proceeds will be invested in new productive infrastructure ("asset recycling");
- electricity network prices will be discounted by 1% off forecast regulated prices until 2019;
- the jobs of permanent award employees will be protected, and treated consistently with previous transactions;
- the transaction will have no adverse impact on electricity reliability, with tight regulation by Government remaining;
- the regional presence of the network businesses will be maintained; and
- Essential Energy will remain in full public ownership.[3]

In announcing its plans to lease the networks, the NSW Government has focused its attention on the ways in which unlocking funds for investment in sizeable infrastructure projects in NSW will benefit NSW residents—giving them better services, more opportunities and an economy that is growing. The Government has also asserted that the partial lease of the electricity networks will allow this growth to occur without the need for sizeable increases to state debt levels or a reduction of Government services.[4]

This Report focuses on the proposed lease from an electricity consumer's point of view and does not discuss the merits of potential new infrastructure projects. NCOSS believes that if the lease does proceed, the NSW Government must invest in social housing as critical productive infrastructure.[5]

Any analysis of the Government's rationale that the part-leasing of the NSW electricity networks will provide an overall benefit to NSW should also consider trade-offs such as future revenue lost from the lease to a third party of the profitable network businesses and the revenue gained up-front from the third party; along with the reduced risk and lower interest costs from state debt. We strongly encourage the Government to be fully transparent about these outcomes as it goes through the detailed due diligence process.

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1 NSW Government, Rebuilding NSW: Discussion Paper, 2014, 3.-5.
2 Ibid, 6.
3 Ibid, 3.
4 Ibid, 4.
5 NCOSS, Submission to the Rebuilding NSW Discussion Paper, 2014. Available online at http://www.ncoss.org.au/resources/140918-Rebuilding-NSW-NCOSS-Submission.pdf

Another critical question also remains; one that does not appear to be adequately addressed in the process set out to date. That is the question of how the partial lease of electricity networks will affect NSW electricity consumers.

Finding an answer requires an understanding of the governance, financial and regulatory mechanisms that are currently in place and those that should be put in place prior to and after any lease. One of the main purposes of this report is, therefore, to investigate the risks and benefits to electricity consumers from privatisation, and more particularly, from the proposed format of the privatisation of the NSW networks.

With the Government taking this issue to the NSW election in 2015, this Report analyses the proposed partial lease of electricity networks from the point of view of NSW electricity consumers. For the purpose of this analysis, NCOSS and its consultants are "agnostic" about whether networks should be held in public or private ownership and this report does not seek to answer the question of whether the NSW Government should go ahead with the lease.

Rather, the purpose of this Report is to foster an informed debate about the impacts the lease might have on electricity consumers, and advocate for lease arrangements that manage the risks electricity consumers may face. We are conscious, for instance, that consumers are deeply concerned about the potential impacts on the prices of network services and the reliability and safety of electricity supply. These issues should be acknowledged by policy makers and addressed through an open, genuine and transparent engagement process.

The report focuses on the need to;

- consider the impact of a lease on the state's consumers of an essential service;
- structure the lease in a way that manages risk and minimises negative consumer impacts; and
- develop consumer protections where these risks cannot be managed effectively.

Public and private ownership both have risks and it would be unreasonable to expect that any process would negate these risks entirely. It is important, however, that the NSW Government have strategies to manage these risks and that these strategies are communicated openly to consumers.

It is also imperative that all costs, benefits and risks that have a bearing on the price and reliability of electricity are weighed publically to ensure the outcomes best serve the longterm interests of NSW electricity consumers.

The National Electricity Objective (NEO), to which NSW has agreed, captures this principle.

The NEO is 'to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers with respect to – price, quality, safety, reliability and security of electricity; and the reliability, safety and security of the national electricity system'.[6]

The challenge for the NSW Government is to ensure its decisions about the ownership arrangements

6 National Electricity Law set out in the Schedule to the National Electricity (South Australia) Act 1996 (SA). The Law was adopted in NSW in the National Electricity (New South Wales) Act, 1997 (NSW). Other states adopted similar Acts.

for the NSW electricity networks deliver outcomes that are in the long-term interests of electricity consumers in NSW as well as the broader NSW community.

As Mr Rod Sims, Chairman of the Australian Competition and Consumer Commission (ACCC), recently highlighted:[7]

'Like most things in life, privatisation can either be done well, or badly.'

Mr Sims noted that where the focus of privatisation is on maximising sale proceeds, the outcome puts at risk the long-term interests of the community.

It is our hope that if the lease proceeds, it will be done well.

NCOSS also hopes that this work will lead to greater transparency as decisions about whether and how to lease the networks are made. NCOSS believes that transparency is an important factor in enabling the people of NSW to make informed choices about whether to support the partial lease of the networks before the election and to engage meaningfully in more detailed discussions if the lease proceeds.

Why is it important to consider electricity consumers?

Any big decision about privatisation has pros and cons. However, it is important that the interests of consumers of an essential service such as electricity are not adversely affected in an attempt to realise big-picture, utilitarian goals. Without careful planning and control mechanisms to mitigate risk, efforts towards achieving these goals may have unintended negative consequences in certain areas of the economy or for certain consumers.

Electricity differs from other products in that it is an essential service: people have little choice over whether or not to buy and consume it. Some people reduce consumption when prices rise beyond their capacity to pay. This strategy can have negative consequences to people's health and wellbeing and can impact people's ability to perform everyday tasks.

People who are unable to pay may be forced to live without electricity for a time. This is extremely difficult in modern society and cuts people off from the ability to communicate, heat or cool their homes, heat water for bathing, study, and seek employment.

The use of electricity across commercial and industrial sectors, and in education facilities, denote it as a key input into the productivity of NSW. There is also a need to recognise that electricity prices, which are linked to network supply areas, impact the costs of goods produced within and outside of NSW. In this way, efficient networks and the prices derived from well-managed network businesses that are effectively held to account contribute to the competitiveness of the state.

Over recent years, NSW has experienced large increases in electricity prices and these have only just started to plateau. The trajectory of NSW Electricity prices is shown in the table overleaf.

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7 Rod Sims, Regulating for efficient infrastructure outcomes, speck to the ACCC/AER Regulatory Conference, August 2014. https://www.accc.gov.au/speech/regulating-for-efficient-infrastructure-outcomes

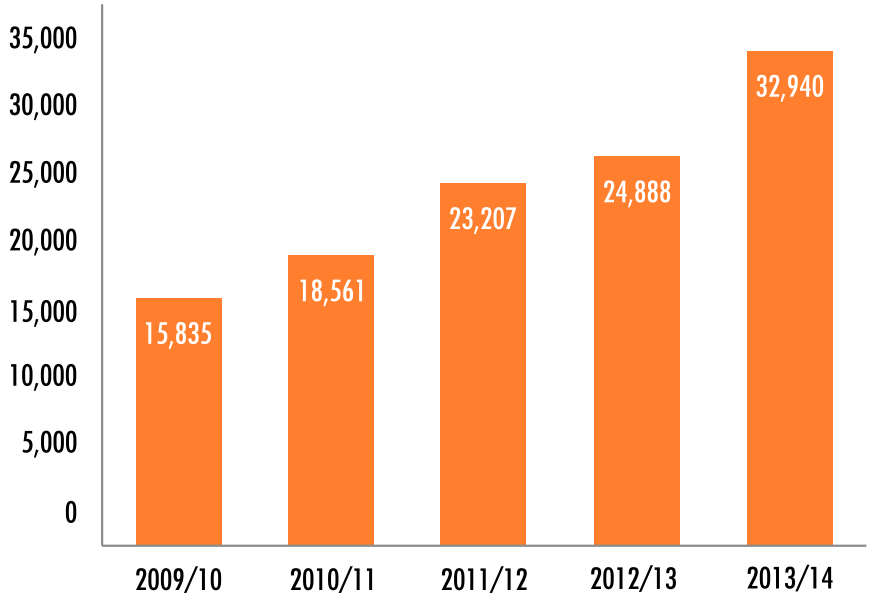
Figure 1: Movements in regulated and standing offer electricity prices

NETWORK SUPPLY AREA	2009/10 %	2010/11 %	2011/12 %	2012/13 %	2013/14 %	AVG. Annual Bill 2013/14 $
Ausgrid	21.7	10	17.9	20.6	3.9	2106
Endeavour Energy	21.1	7	15.5	11.8	1.6	2044
Essential Energy	17.9	13	18.1	19.7	-0.6	2725

Source: AER State of the Energy Market 2013, 130.

Since 2009, disconnections for inability to pay have also risen substantially. Despite smaller price rises in 2013/14, the influence of high cumulative rises over recent years is still influencing affordability. Growing disconnection rates, shown in Figure 2, illustrate the outcome of this trend.

Figure 2: Residential customer disconnections for non-payment (NSW) 2009-10 to 2013-14



Source: Australian Energy Regulator (AER).[8]

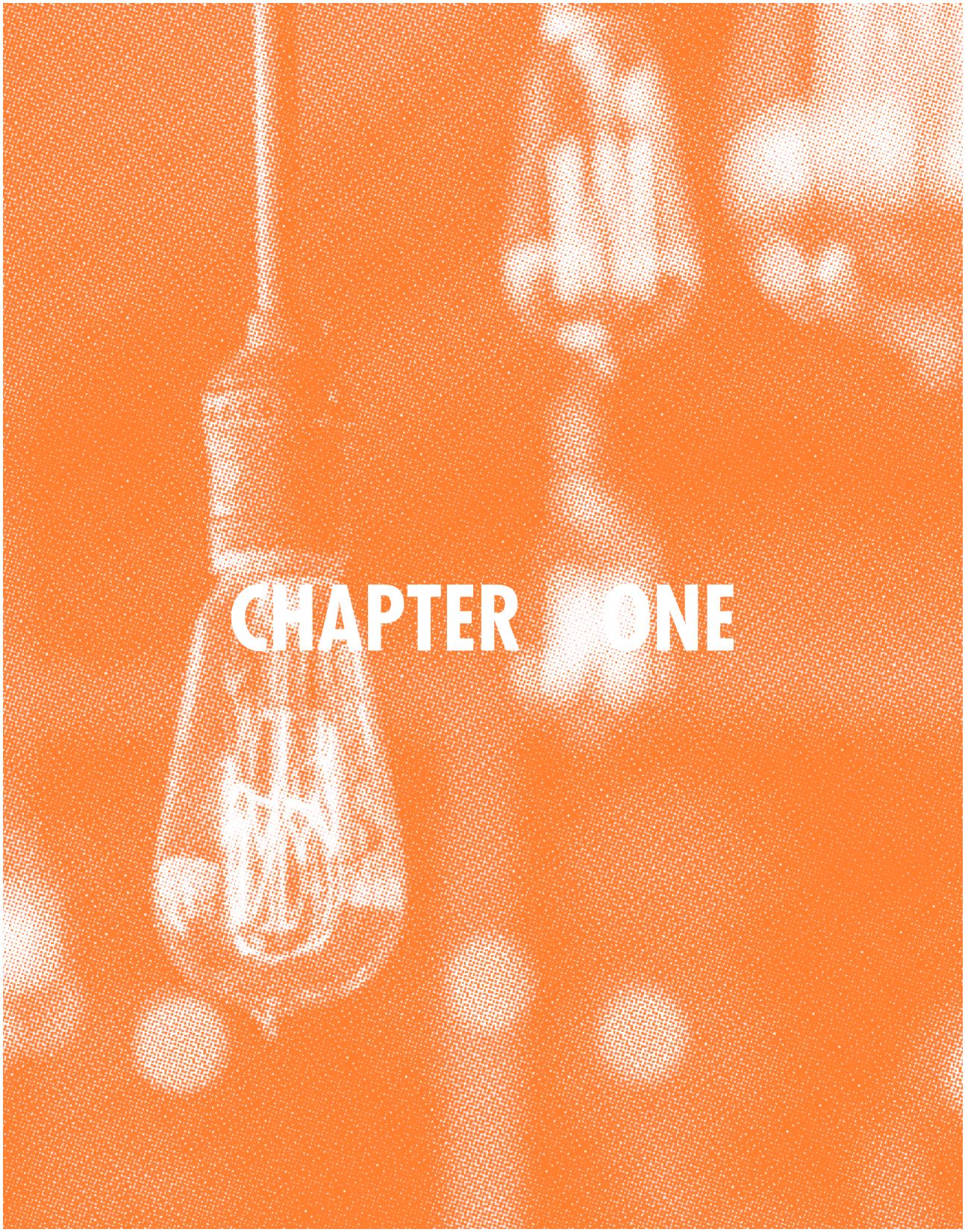
The fact that disconnection rates have risen by 32 per cent in the last financial year affirms why NSW community organisations attending an NCOSS cost of living roundtable recently nominated energy as a key issue for their constituencies.

8 Australian Energy Regulator, Annual Report on the performance of the retail energy market 2013-2014, 2014, 36.
9 AER, State of the Energy Market, 2013, 129.

Under current ownership structures, electricity network prices make up over 50% of the price people pay on their household electricity bills in NSW.[9] According to the Australian Energy Market Commission (AEMC), networks costs 'make up 59% of the average market offer price in NSW.' [10]

As price plays such an integral role in determining access to an essential service, it is important that consideration is given to partial lease arrangements and how resulting ownership changes will impact prices both now and in the future. Reliability and safety are also very important in determining positive consumer outcomes.

10 AEMC, NSW Electricity Price Trends, 2013, 2.


CHAPTER ONE

Where Are We Now?

This Chapter outlines the current ownership arrangements for the NSW Networks and plans for the structure of the lease. Potential impacts of the proposed lease structure on Networks NSW and Essential Energy are also discussed.

1.1 Current network ownership

The four NSW electricity network businesses, Ausgrid, Endeavour Energy, Essential Energy and Transgrid currently operate as statutory state-owned corporations. The NSW Treasurer and the NSW Minister for Finance are the two voting shareholders for each of these businesses on behalf of the NSW Government[11] and the NSW Minister for Energy is the portfolio minister for the four network businesses. Under the State-Owned Corporations Act 1989 (NSW), the portfolio minister can, with the approval of the Treasurer, direct the businesses on certain matters including public interest, public sector policies and noncommercial activities.[12]

In 2012, the NSW Government announced a series of reforms to save over $400 million by amalgamating the three distribution network businesses (Ausgrid, Endeavour Energy and Essential Energy) under one umbrella known as Networks NSW. As part of these reforms a common board and CEO was appointed for the three distribution networks.[13] These reforms were instigated to realise cost and efficiency savings through standardisation of purchasing and rationalisation of corporate and administration costs.[14] Transgrid, the state's transmission network business, was not included under this umbrella and remained a stand-alone business.

1.2 Partial lease proposal

The NSW Government has agreed to maintain ownership of Essential Energy—the distributor that covers most of rural and regional NSW. It is considering what proportion of the remaining distributors, Ausgrid and Endeavour Energy to lease long-term.

Under a goal to maintain a 51 per cent majority ownership, it may also lease part of Transgrid—the state's single transmission network. A Scoping Study is investigating what proportion of the assets of these businesses will be leased. The Scoping Study will also look at transaction design, timeframes and retention values and methods for managing the assets remaining under state-ownership.[15]

The Government has also noted its preferred approach that the 51 per cent of network assets that will not be subject to the long-term lease will be held in the NSW Future Fund.

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11 Essential Energy, Annual Report 2012-2013, 2013, 24.
12 NSW Government, State-owned Corporations Act 1989 (NSW), see sections 20N, 20O and 20P respectively.
13 Ausgrid, New directors appointed for NSW electricity network businesses, Media Release, 21/12/2012 at http://www.ausgrid.com.au/Common/About-us/Newsroom/Media-Releases/2012/December/Networks-NSW-directorsappointed.aspx?page=1&year=2012&month=12&id=5dc6b7ee-56b3-4a69-bb6a-46352d18564f
14 The Hon Chris Hartcher, Minister for Resources and Energy, Electricity Network Merger to provide benefits to NSW Households, Media Release, 18 March 2012. http://www.resourcesandenergy.nsw.gov.au/__data/assets/pdf_file/0010/428590/Electricity-network-mergerto-provide-benefits-to-nsw-households.pdf
15 NSW Government, Keeping the lid on household costs, Media Release, 10 June 2014, at https://www.nsw.gov.au/media-releasespremier/keeping-lid-household-costs

The NSW Future Fund will be set up as a statutory asset fund that is independently governed. It will be responsible for protecting the value of assets held by the State and funding future liabilities such as superannuation of the public sector.[16]

The Government's discussion paper, Rebuilding NSW, has set out a number of conditions it will impose in the lease process to protect the public interest. These are listed as:

- all net proceeds will be invested in new productive infrastructure;
- electricity network prices will be discounted by 1% off regulated prices until 2019;
- the jobs of employees will be protected, and treated consistently with previous transactions;
- the transaction will have no adverse impact on electricity reliability, with tight regulation by Government remaining;
- the regional presence of the network businesses will be maintained; and
- Essential Energy will remain in full public ownership.[17]

1.2.1 Asset recycling and incentives to do so

The partial lease of the electricity networks is expected to release $20 billion dollars for reinvestment into sizeable infrastructure projects. These projects are promoted as being capable of providing a range of benefits for NSW residents—giving them better services, more opportunities and an economy that is growing.[18] The NSW Government asserts that securing funding through the partial lease of the electricity networks will allow this growth to occur without the need for large increases to state debt levels or a reduction of Government services.[19] The Government also notes that the partial lease of the networks will reduce its exposure to the risks of debt and calls on capital that it faces as the owner of these businesses.[20]

The NSW Government has identified priority projects that it intends to fund with the proceeds of the lease. These projects include:

- $1.1 billion to invest in the WestConnex northern and southern extensions, and the Western Harbour Tunnel;
- $1.3 billion for other Urban Road Projects
- $7 billion for Sydney Rapid Transit, to fully fund a second Harbour rail crossing;
- $300 million for Bus Rapid Transit and Bus Priority Infrastructure

16 NSW Government, Rebuilding NSW, Protecting the public interest in poles and wires, Fact Sheet 9, June 2014, https://www.nsw.gov.au/sites/default/files/miscellaneous/sc000151_dpc_fact_sheet_09.pdf and NSW Government, Keeping the lid on household costs, Media Release, 10 June 2014, https://www.nsw.gov.au/media-releases-premier/keeping-lid-household-costs
17 NSW Government, Rebuilding NSW: Discussion Paper, 2014, 3.
18 Ibid, 3.
19 Ibid, 4.
20 Ibid, 7.

- $600 million for Parramatta Light Rail;
- $1 billion for Sydney's Rail Future 2 upgrades;
- $1.2 billion Sports and Cultural Fund, capitalising on existing iconic assets andprecincts, and increasing the presence of facilities in Western Sydney; (up from $500 million)
- $4.1 billion for regional transport;
- $1 billion for regional and metropolitan schools;• $1 billion for regional and metropolitan hospitals;
- $1 billion for water security for our regional communities;
- $300 million for Regional Tourism and the Environment; and
- $100 million for corridor identification and reservation.[21]

The timing of this proposal is somewhat influenced by asset recycling incentives offered by the Commonwealth Government. The Asset Recycling Initiative offers incentives for State/Territory Governments to 'privatise mature government-owned assets and reinvest the returns into new, productivity-enhancing infrastructure.[22] The Initiative is set to close in mid-2019. Before then, it offers a 15% incentive to Governments that privatise 'mature assets' and reinvest the funds released into new productive infrastructure.[23]

1.2.2 The lease structure

While the NSW Government has provided considerable information about the way in which it plans to invest the proceeds of the lease, there is not a great deal of detail about the way in which the lease will be structured. Without this information, it is difficult to assess how electricity consumers may be impacted by the partial lease proposed in the Rebuilding NSW Discussion Paper.

Given the Government has committed to retain 100% ownership of Essential Energy, it is understood that achieving 51% ownership of the networks may mean that the Government will not have a majority share in one or all of the remaining businesses.

The Government has said that the Scoping Study would investigate possible ownership structures and leasing conditions; and that this study would report to the Government in late November.[24] As outlined in the high-level recommendations of this Report, it is vital that the findings of that Study are made public so people approach the upcoming election with detailed information about how the lease may affect them specifically as consumers of an essential service.

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21 NSW Government, Rebuilding NSW: State Infrastructure Strategy 2014, 2014, 2.
22 Commonwealth Government 2014, The Asset Recycling Initiative, Fact Sheet, accessed 17 November 2014 at http://investment.infrastructure.gov.au/publications/reports/pdf/factsheets2014/Factsheet_The_Asset_Recycling_Initiative.pdf
23 Ibid.
24 NSW Government, Rebuilding NSW: Discussion Paper, 2014, 7.

1.3 Public and private ownership of networks

This Report is based on a vision that electricity networks, regardless of ownership, should be proactively managed to ensure consumers do not pay any more than necessary for a reliable and safe supply of electricity. Both privatisation and public ownership of electricity networks have positives and negatives, and for the purposes of this analysis, NCOSS and its authors remain agnostic about whether public or private ownership delivers the best outcomes for consumers.

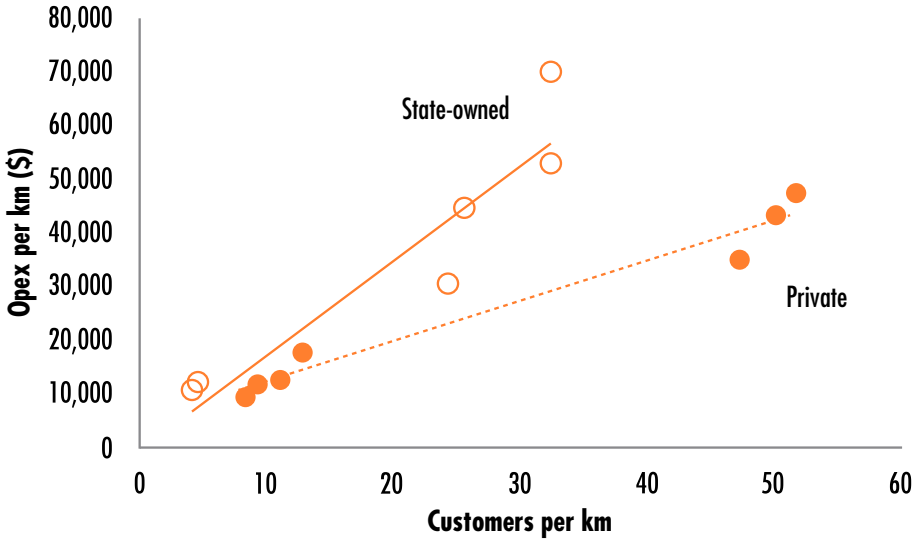
What we are very clear about, however, is that any ownership structure should work to maximise benefits and minimise risks for consumers. This holds true whether or not the partial lease proceeds after the election.

The public sphere includes discussion of the benefits of both public and private ownership of essential monopoly services. A report by Frontier Economics, released as part of the Rebuilding NSW consultation process includes references to some positive aspects of private ownership.[25] The Government itself has recorded its expectation that networks will become more efficient over time due to partial leasing.[26]

The Productivity Commission recently recommended that state and territory governments privatise their electricity networks[27] citing a body of evidence that privately-owned networks have lower operating and capital expenditure costs compared to their publicly-owned counterparts. For example, AER data was used to compare the operating expenditure of privately-owned distribution networks with their publicly-owned counterparts. This analysis included population density, as it would be unfair to expect similar performance levels across variable economies of scale. Their findings are shown at Figure 3 on the opposite page.

25 Frontier Economics, Regulatory arrangements for electricity network pricing, 2014, iv, 35, 37, 40.
26 NSW Government, Rebuilding NSW: Discussion Paper, 2014, 12.
27 Productivity Commission, Electricity Network Regulation, vol 1, 2013, 58, recommendation 7.1.

Figure 3: Operating expenditure and customer density for state-owned and privately owned electricity distribution networks



Data source: Data requested from the AER based on AER (2011b), p. 64.

Figure Source: Productivity Commission, Electricity Network Regulation[28]

More recently, the AER's 2014 report benchmarking network performance confirmed that privately owned networks in South Australia and Victoria had higher levels of total-factor productivity (a measure of operating and capital expenditure efficiency)—although NSW levels were trending upward.[29]

Of course, the variation in reliability standards across jurisdictions should be remembered when weighing these differences.

Benefits of public ownership of electricity assets include:

- the government's ability to direct the businesses to deliver outcomes in the public interest;
- voters in NSW have some capacity to exert political pressure where these businesses do not deliver according to public expectations; and
- the income generated by these businesses as dividends and other fees is a revenue stream that benefits the state overall.

Mr Rod Sims, Chair of the Australian Competition and Consumer Commission (ACCC) and former

28 Productivity Commission, 2013, Electricity Network Regulation, vol 1, 2013, 258, Figure 6.15.
29 AER, Annual Distribution Benchmarking Report, 2014, 32.

Chair of the NSW Independent Pricing and Regulatory Tribunal (IPART) has declared himself a supporter of privatisation.[30] He has, however, qualified his support for the privatatisation of commercial operations, noting it was a preferred option:

'unless there is a clear public policy objective that can demonstrably best be met by continuing public ownership.'[31]

In 2012, the NSW Government acted in line with an objective to respond to the impact of rising electricity prices on NSW households. Then Energy Minister, the Hon. Chris Hartcher, requested network businesses "cap" price rises at CPI or below over the next regulatory period.[32] The Minister's request came at a time of rising electricity prices and associated media scrutiny —making electricity prices a key political issue – and networks duly complied with this request when preparing their regulatory proposals for the AER. While it has been argued that stronger direction could have achieved greater savings, the point being made here is that governments have the capacity to respond in this way and to direct both Stateowned Corporations and the regulators to have regard for the government's policy directives.

If the networks were privately owned, the NSW Government would not have this level of influence. Before the lease structure is finalised, the Government should undertake an analysis of whether the regulatory framework includes sufficient protections to respond in the public interest in the event of extraordinary circumstances.

If it does not, the Government should assess whether changes to the regulatory framework or the introduction of some kind of reserve powers are necessary before proceeding with the lease. In the interest of transparency, decisions about how best to deal with extraordinary circumstances should be made prior to the networks being offered for lease and any changes to the regulatory framework, such as the introduction of reserve powers, should only occur after meaningful public consultation with consumers, industry and others.

Recommendation 1: The NSW Government should assess whether changes to the regulatory framework or the introduction of reserve powers are necessary to elicit responses from networks that are in the public interest where extraordinary circumstances occur.

This assessment should occur prior to the lease and decisions about changes should be made before the networks are offered for lease to maximise transparency.

Any change to the regulatory framework, such as the introduction of reserve powers, should only occur after meaningful public consultation with consumers, industry, regulators and others.

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30 Rod Sims, The need to elevate competition in our public policy, speech at the CEDA State of the Nation Conference, 23 June 2014. https://www.accc.gov.au/speech/the-need-to-elevate-competition-in-our-public-policy
31 Ibid.
32 Chris Hartcher, NSW Minister for Energy, Submission to IPART Review of regulated retail prices and charges for gas, 2013-2016, 5 February 2013. http://www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews/Retail_Pricing/Review_of_regulated_gas_retail_tariffs_and_charges_2013_to_2016/27_Nov_2012_-_Issues_Paper/Issues_Paper_-_Review_of_regulated_retail_prices_and_charges_for_gas_2013_to_2016_-November_2012

1.4 The partial lease: a privatisation hybrid?

One recurring theme surrounding privatisation is that the privatisation process itself is very important in realising long-term benefits. As quoted earlier, Rod Sims' comment that 'privatisation can either be done well, or badly',[33] provides some element of forewarning.

Similarly, his rationale that 'the reason to privatise assets is to promote economic efficiency'[34] raises questions about whether the partial lease of the electricity networks is best placed to deliver the best, or worst, of both worlds.

Partial ownership of a network is more complex than a long-term lease or sale of a business as a whole. As such, there are a number of questions that should be answered to allow electricity consumers and their advocates to make informed choices about whether to support the lease under this model.

Some of these questions include:

- Can the efficiencies often linked with private ownership be delivered in a public/private partnership, and if so, how will this occur?
- How will the state's retention of 51% ownership of the networks impact on the businesses' status as State-owned Corporations and will the Government retain any power to direct the networks to act in the public interest in extraordinary circumstances?
- If the Government's expectation is that the networks will become more efficient as a result of privatisation, what steps will be taken to introduce efficiencies in the Essential Energy distribution supply area?
- Will the Government as a 51% owner of the network businesses be under any obligation to provide access to capital or capital guarantees?
- How will the partial lease affect the Government's exposure to the risks of debt, given it will be a large shareholder?
- How will the partial lease affect the Government's exposure to operational risks, given it will remain a large shareholder?

1.4.1 Networks NSW: will the benefits continue?

When the NSW Government announced a series of reforms to save over $400 million by amalgamating the three distribution network businesses under one umbrella known as Networks NSW, it outlined the capacity for an integrated structure to deliver cost savings.[35]

The Government has since acknowledged that network reforms related to the formation of Networks

33 Rod Sims, Regulating for efficient infrastructure outcomes, speech to the ACCC/AER Regulatory Conference, August 2014. https://www.accc.gov.au/speech/regulating-for-efficient-infrastructure-outcomes
34 Ibid.
35 The Hon Chris Hartcher, Minister for Resources and Energy, Electricity Network Merger to provide benefits to NSW Households, Media Release, 18 March 2012. http://www.resourcesandenergy.nsw.gov.au/__data/assets/pdf_file/0010/428590/Electricity-network-mergerto-provide-benefits-to-nsw-households.pdf

NSW have resulted in significant savings, and that these were projected to continue. Budget Papers for the 2013-14 year state:

'The integration of the three State-owned electricity distributors is estimated to deliver savings of $600 million in operational expenses and $1.9 billion in capital savings over the five years to 2015-16.'[36]

The 2014-2015 Budget Papers announced this reform had exceeded expectations andrealised huge savings. The papers noted:

'The integration of the operations of the three electricity distribution businesses was formalised in August 2013 to create a joint Board and allow that Board to act in the interests of the combined entity. The focus on business efficiencies across Ausgrid, Endeavour Energy and Essential Energy has generated operating cost and capital savings of over $500 million and $4.8 billion respectively over the five year period to 2015-16, far exceeding the savings initially forecast.'[37]

One of the key functions of Networks NSW was the amalgamation of the three distribution businesses under the one umbrella. At the time, Minister Hartcher declared savings would result from reducing administrative and corporate costs and standardising purchasing and IT processes.[38]

Minister Hartcher also declared:

'This is about implementing a common operating model that will deliver big savings .'[39]

Today, it is unclear whether the partial lease of two of the three businesses under Networks NSW will affect savings forecast for future periods as noted above. Without further information, it is also difficult to see how integrated IT systems, purchasing and Board structures could continue under a change of ownership.

The loss to consumers would be two-fold if future savings are not delivered and if the disintegration of, or a substantive change to, Networks NSW resulted in the reintroduction of costs, such as individual Boards for each network business.

Recommendation 2: The NSW Government should publicly demonstrate whether the actual and projected savings from Networks NSW will be affected positively or negatively by the partial lease.

This demonstration should include an outline of whether cost savings from the aggregated governance of distribution networks under Networks NSW will be lost or reduced as a result of the partial leasing of Endeavour Energy and Ausgrid.

36 NSW Government, Budget Paper No.2: 2013-2014 Budget Statement, Chapter 9, Public Trading Enterprises, 9.
37 NSW Government, Budget Statement 2014-2015: Budget Paper No 2, 2014, Chapter 9,1.
38 The Hon Chris Hartcher, Minister for Resources and Energy, Electricity Network Merger to provide benefits to NSW Households, Media
Release, 18 March 2012. http://www.resourcesandenergy.nsw.gov.au/__data/assets/pdf_file/0010/428590/Electricity-network-mergerto-provide-benefits-to-nsw-households.pdf
39 Ibid.

1.4.2 Essential Energy

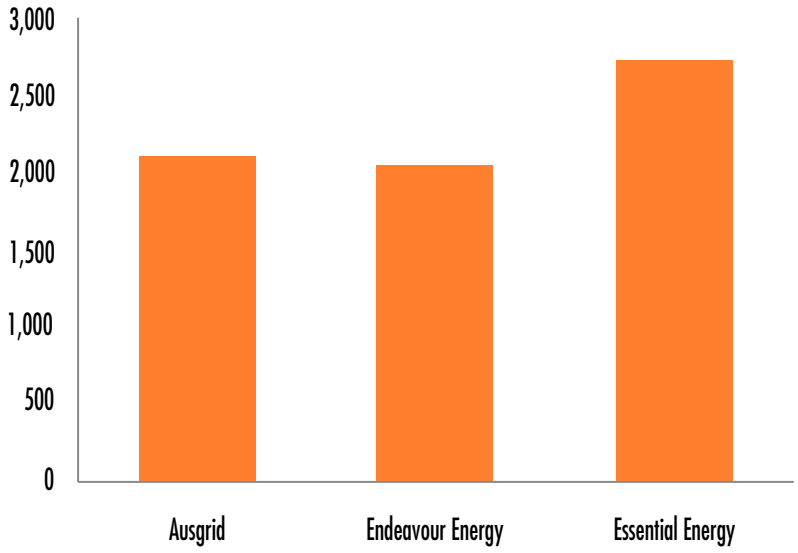
Even though the partial lease process may appear to have little impact on Essential Energy, as it will remain under full government ownership, any changes to Networks NSW may have an impact on its cost structures going forward. Given Essential Energy's customer base is less than half size of Ausgrid's,[40] any costs reintroduced or savings lost will have a greater impact per customer in an area that already has the highest electricity prices in the State.

If one were to agree with the NSW Government that networks will become more efficient as a result of partial leasing to the private sector, it could also be argued that there is room for efficiency gains within the networks (or portions thereof) that are to remain under government ownership. The Government has committed to retaining 100 per cent ownership of Essential Energy and it is important that customers in this network have access to all the benefits efficiency can provide.

Efficiency is often used as a catch-all phrase. In this context, it is used to seek best practice in operating networks and investing in network infrastructure in accordance with the regulatory framework. As the AER's Benchmarking report referred to earlier notes, there is still room to improve the efficiency of the NSW networks.

NSW electricity consumers stand to benefit from efficiency gains through lower prices. As Figure 4 demonstrates, customers in the Essential Energy network supply area pay over $600 dollars per year more than their counterparts in metropolitan Sydney.[41]

Figure 4: Average annual electricity bill by NSW distribution network supply area



Source: AER State of the Energy Market 2013, 130.

40 Ausgrid has 1,637,000 customers compared with Essential Energy's 803,496, according to the AER State of the Energy Market 2013, 63.
41 AER, State of the Energy Market, 2013, 130

It should be remembered that the costs of running a large rural network are of course different from network running costs in Sydney where population density and economies of scale help to reduce costs that can be spread over a larger customer base. However, this should not preclude Essential Energy from seeking the most efficient outcomes within the bounds of the regulatory framework and standards for safety and reliability.

If the partial lease does go ahead and Essential Energy becomes the only network that remains 100 per cent government-owned, the NSW Government will need to ensure that Essential Energy does not lose any economies of scale or other efficiencies it gained through the amalgamation of the distribution businesses under Networks NSW.

Recommendation 3: The NSW Government should demonstrate publicly and comprehensively how it will maximise efficiency in the portions of the NSW electricity networks that remain under its ownership.

Recommendation 4: Prior to the NSW Election, the NSW Government should outline its proposed governance structure for Essential Energy including an outline of costs driven by any changes to governance structures, or substantive changes to Networks NSW; and any loss of economies of scale that may result if Essential Energy becomes a stand-alone government-owned network.

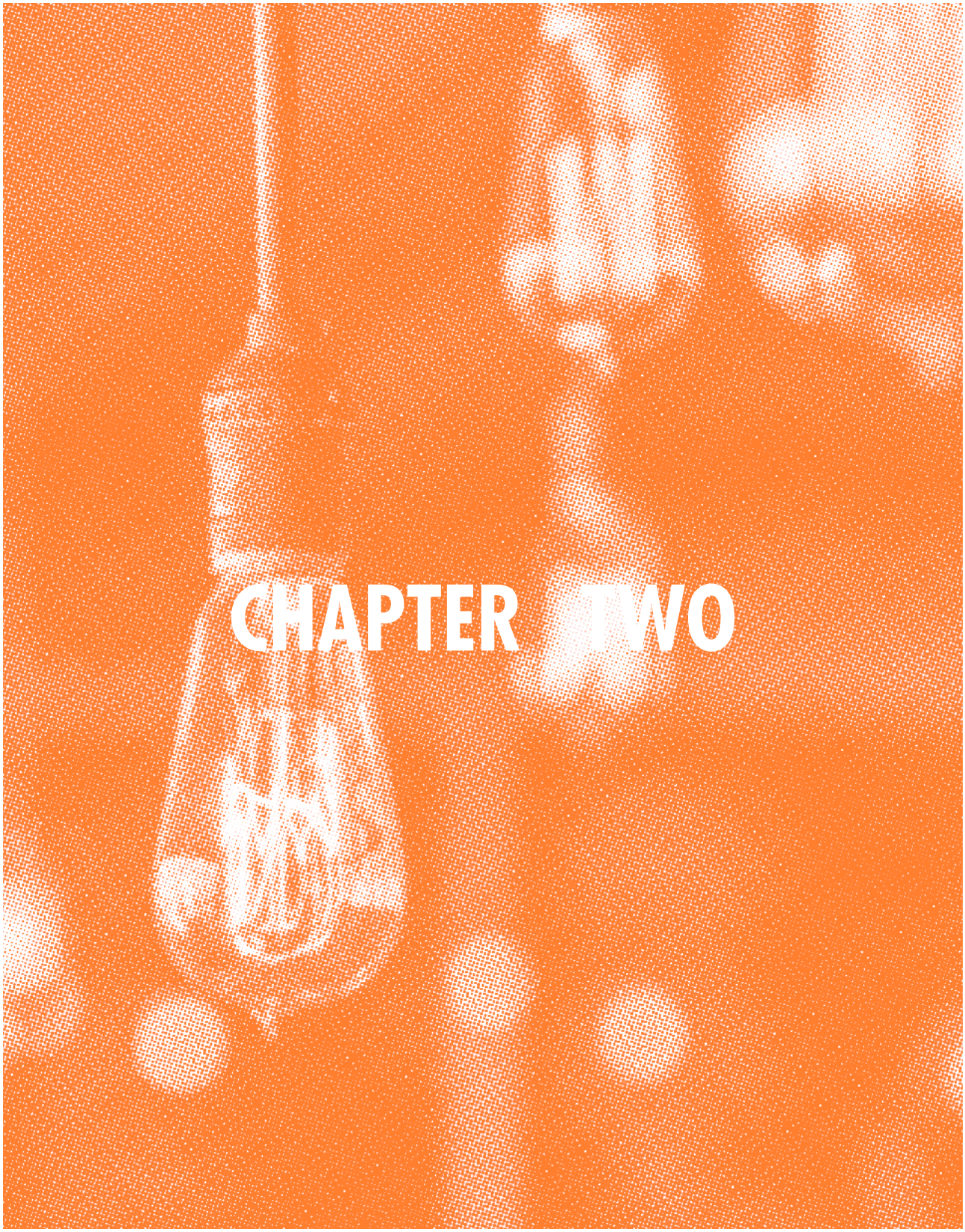
1.4.3 Weighing the cost (and benefits) of a hybrid approach

Given the complexities of partial privatisation discussed in this Chapter, it vital that the Government develop a detailed analysis of all risks, benefits and costs arising from changes to NSW electricity networks that may result from their approach to partial privatisation. This analysis must also consider the impact on the remaining government-owned networks and the costs of disbanding Networks NSW if this is to occur.

The fact that the government's model is neither a privatisation of assets, a full leasing of the assets, or a complete retention, makes it all the more necessary for the Government to identify and quantify these risks and benefits and develop clear strategies to manage them.

This information should be disclosed to the people of NSW for their comment before any model is finalised.

Recommendation 5: The NSW Government should identify, quantify and develop strategies to manage and mitigate any risks that arise from joint ownership under a partial lease. This information should be made available to consumers prior to any lease structure being finalised.



CHAPTER TWO

Governance & Accountability

In discussing the proposed infrastructure program for NSW, the NSW Government agrees that the public 'expects a robust governance framework to ensure that commitments are followed through, and are delivered on time and on budget.'[42]

The expectation of robust frameworks should also be applied with respect to the governance of the NSW electricity networks, and indeed, this is essential to ensuring electricity consumers are not adversely impacted by the proposed ownership arrangement.

Electricity consumers need to understand how their networks will operate, who will make decisions and who is accountable under the partial lease model. They also need to be shown how complex ownership structures that include government ownership, partial leasing, and independent management can foster efficient and effective direction of monopoly essential services.

Poor governance arrangements will put the future interests of consumers at significant risk and this Report therefore recommends that NSW consumers should be informed of all key aspects of corporate governance (as set out below) prior to the sale. The NSW Government should make clear how it proposes to monitor and evaluate whether businesses are effectively and efficiently directed under new ownership structures. It should also disclose what reserve powers it will hold to address any major issues that may arise in the strategic direction or operation of the businesses, while ensuring the Board remains accountable for its decisions.

2.1 Corporate governance and relevant governance principles

The Australian Securities Exchange (ASX) sets out a number of principles and recommendations for corporate governance for ASX listed companies.[43] The ASX defines corporate governance as follows:[44] 'the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations.' It encompasses the mechanisms by which companies, and those in control, are held to account. Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised.

Effective corporate governance structures encourage companies to create value, through entrepreneurialism, innovation, development and exploration, and provide accountability and control systems commensurate with the risks involved.

The key principles that underpin the ASX's assessment of good governance, and which the ASX regards as 'equally important' include:[45]

1. Establishing the roles of the board and senior executives;

42 NSW Government, Rebuilding NSW: Discussion Paper, 2014, 4.
43 Australian Securities Exchange (ASX) Corporate Governance Council, Corporate Governance Principles and Recommendations with 2010 Amendments, 2nd Edition. http://www.asx.com.au/documents/asxcompliance/cg_principles_recommendations_with_2010_amendments.pdf
44 Ibid, 3. The definition used by the ASX reflects comments by Justice Owen in his report from the HIH Royal Commission (The Failure of HIH Insurance, Volume 1: A corporate Collapse and its Lessons), April 2003 @ page xxxiii.
45 Adapted from Ibid.

2. A balance of skills, experience and independence of board members;

3. A need for integrity and ethical decision-making that takes into account legal and regulatory obligations and interests of stakeholders;

4. Establishing processes that safeguard both internally and externally, the integrity of company reporting;

5. Provide a timely and balanced picture of all material matters;

6. The rights of all shareholders to be clearly recognised and upheld;

7. Management of risk through effective oversight and control; and

8. Remuneration arrangements are sufficient and reasonable and their relationship to performance is clear.

The ASX sets out a list of 30 recommendations linked to these principles, many of which are relevant to the NSW Government's proposals and should be taken into account.

These principles provide a strong basis for considering the governance framework under the partial leasing arrangements. Given the mix of public and private ownership that may result if the lease proceeds, it is even more important that the Government sets out its expectations about the governance rules, relationships and systems prior to the drafting of lease structures and conditions. Similarly, it is essential that there is clarity about accountability, objectives, priorities, remuneration policies, risk parameters and control systems—along with promoting a culture of entrepreneurialism and innovation for the future of the businesses. These principles are equally relevant to the governance arrangements for Essential Energy, even though it remains wholly in public ownership. If the lease precipitates the need for Essential Energy to have its own Board once again, an independent board, selected on merit and with clear accountability for defining and implementing the strategic direction, executive appointments and the overall performance of Essential Energy is central to consumers in that network area deriving the same level of price and service benefits as consumers in other network areas.

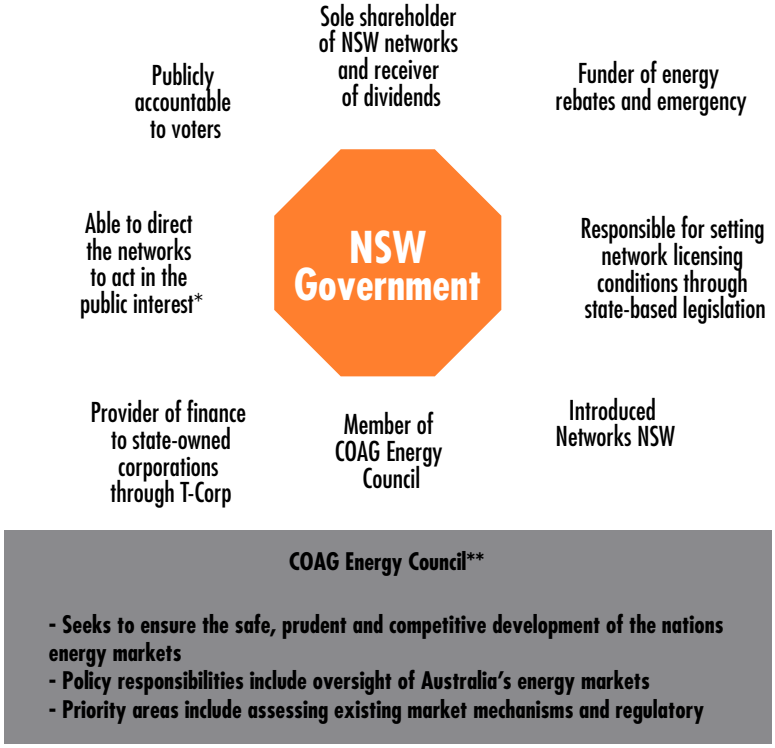
A number of aspects of the corporate governance framework are discussed in further detail below.

2.2 NSW Government roles

If the Government is to play multiple roles through future involvement in network governance

– including both as shareholders and as holders of regulatory responsibilities such as setting conditions of network licensing – there is a need to assure consumers that systems are in place to manage any conflicts of interest that may arise.

Figure 5: Snapshot of NSW Government roles in electricity networks



* See State-Owned Corporations Act 1989 (NSW) section 20P.
** Sourced from SCER Terms of Reference

Figure 5 above shows some of the roles currently played by the NSW Government in the electricity sector. Should the partial lease go ahead, the roles and responsibilities private owners will have under the governance structure developed to facilitate the lease will need to be clarified, as will any changes to the Government's current roles.

2.3 Strong, independent and well-resourced regulation

Strong regulation and good governance are recurring themes when discussing the oversight of electricity networks. Strong independent regulation, driven by well-resourced regulators, will be even more important after the lease—especially if the Government forgoes its capacity to direct businesses in the public interest as per the State-Owned Corporations Act 1989 (NSW).

When recommending that Governments privatise their electricity networks in 2013, the Productivity Commission suggested that Governments should 'undertake key regulatory reforms prior to any sale.'[46]

While national regulations and law covers much of the electricity network regulatory framework, the setting of network license conditions including reliability standards; and policies regarding access to

46 Productivity Commission, 2013, 293, recommendation 7.3.

Government capital and dealing with competitive neutrality, sit within the jurisdiction of the NSW Government.

As such, the Government should take this opportunity to review whether state-based legislation and policies will need to be adjusted under new ownership structures. This review should include an analysis of how the network's current status as State-owned Corporations will be affected; and whether the regulatory framework includes sufficient protections to deliver outcomes in the public interest where extraordinary circumstances occur. The review should also explore options for the Government (as a part owner) to pass regulatory responsibilities to an independent regulator that is sufficiently resourced to undertake its duties in the long-term interest of consumers.

If the partial lease results in the Government becoming a largely silent shareholder, then it is even more important to ensure that the regulatory framework, at both state and national levels, is strong, independent and well resourced.

The regulatory framework and the need for strong, independent regulators are discussed in more detail in Chapters 5 and 6.

According to the Victorian Government, one of the successes of its mid-nineties privatisation processes was the 'establishment of a stable and predictable economic regulatory regime, administered at arm's length from Government.'[47] While this process predates the national regulatory framework and the formation of the Australian Energy Regulator, the principles of ensuring stable, predictable regulatory frameworks that are independent of government and any of network owners are ones that should apply to this process.

This does not mean that the NSW Government should abandon any role in the industry. The NSW Government is still responsible for setting jurisdictional energy policy (albeit seeking to align this with national energy policy where possible). In addition, the NSW Government, as a member of COAG and the COAG Energy Council (CEC), has the opportunity to influence developments in the energy market, and indeed should take a leadership role in this process.

Recommendation 6: Prior to the NSW Election, the Government should clarify how the partial lease will change the Government's current role, especially in regard to providing finance to, and guaranteeing debt of electricity networks.

Recommendation 7: Prior to the electricity networks being offered for lease, the NSW Government should review whether the partial lease will necessitate adjustments to statebased policies and legislation. This review should include;

- an analysis of how the network's current status as State-owned corporations will be affected
- a determination of whether the regulatory framework under a new ownership structure, includes sufficient protections to deliver outcomes in the public interest where extra-ordinary circumstances occur; (as per Recommendation 1) and

47 Auditor General, Special Report No. 38 – Privatisation: An audit framework for the future, 1995, 14, accessed 20/11/14 at http://www.audit.vic.gov.au/publications/1995/19951122-Special-Report38-Privatisation-Audit_Framework.pdf

- an exploration of methods for the Government (as a part owner) to hand any regulatory responsibility it has over to an independent regulator that is sufficiently resourced.

Recommendation 8: Regardless of whether the above review goes ahead, the NSW Government should consult with regulators at state and national levels to investigate whether partial ownership arrangements will have any impact on regulatory oversight and resource requirements to ensure best practice.

2.4 Accountability

The previous Chapter's discussion of the complexity of the partial lease model is also relevant in terms of accountability under the hybrid of public and private ownership of networks. Regardless of whether one agrees with the sentiments, a complete privatisation would have answered commentators who note intra-governmental conflicts, multiple objectives and political (rather than economic) considerations as downsides of government ownership.[48]

While the continuation of full public ownership provides a reasonably clear understanding of accountability, the public information about the proposed partial lease is yet to answer questions of accountability and how joint ownership fosters transparency in this regard.

It will be necessary to introduce a governance structure that is capable of managing the interests of both public and private shareholders. Electricity networks are capital-intensive businesses and strategic decisions made at the Board level can have a real impact on electricity consumers and the prices they pay. Before being asked to provide a mandate for the partial lease, consumers will need more information about who is accountable, and if accountability is shared, how this is to work.

To ensure transparency and facilitate informed decisions by consumers about whether to support the lease, the Government must consider and communicate answers to the following questions.

Under the partial lease model, who will be accountable for:

- management of the networks;
- setting priorities;
- investment/strategic planning
- capital planning/raising capital;
- provision of debt guarantees;
- appointing the Board, including the independent members of the Board, the CEO and Senior Executives of the partially leased networks;
- remuneration policy;

48 See Yarrow, Sims and the Productivity Commission in Electricity Network Regulation, Productivity Commission, 2013, 268-272.

- deciding on levels of representation of public and private interests at Board level; and
- performance, including;
    - o financial failure; and/or
    - o operational failure.

Consumers will rightly want to know that the governance structures in place are capable of looking after their interests as part-owners and customers of a monopoly essential service. If the lease changes Government accountability with regard to electricity networks, consumers will also want to know who is accountable under new ownership structures.

Similarly, shared ownership between public and private interests will necessitate a transparent process through which conflicting objectives can be prioritised. The Productivity Commission made the recommendation for a transparent process to prioritise conflicting objectives within governments, where those governments decided to retain state ownership of electricity networks.[49] Given that objectives between public and private shareholders may vary on occasion; and some conflicting objectives within government may occur, the need for such a process increases under a partial lease model.

Recommendation 9: Prior to the NSW Election, the NSW Government should outline its proposed governance structure for networks under the partial lease proposal.

This outline should include clarification of who will be accountable under the partial lease model for:

-management;

-setting priorities;

-investment and strategy planning;

-capital planning/raising capital;

-remuneration policy;

-setting parameters for representation on the Boards; and

- accountability for financial and operational performance.

Recommendation 10: The NSW Government should develop a transparent process to prioritise and manage objectives where public and private owners have conflicting objectives and/or where conflicting objectives within different areas of Government exist.

49 Productivity Commission, 2013, 56, recommendation 7.2.

2.5 An evaluation of value and success

If it proceeds, the partial lease of electricity networks will bring about a number of changes. After the fact, people will want to know whether the lease was undertaken in a way that protected their interests and realised value for them specifically as consumers of an essential service.

To this end, a public independent evaluation of the lease process and its outcomes should be carried out once the lease is finalised, with the measures used in evaluating the lease process set now. This will enhance transparency and allow adequate data and evidence to be collected as the process develops.

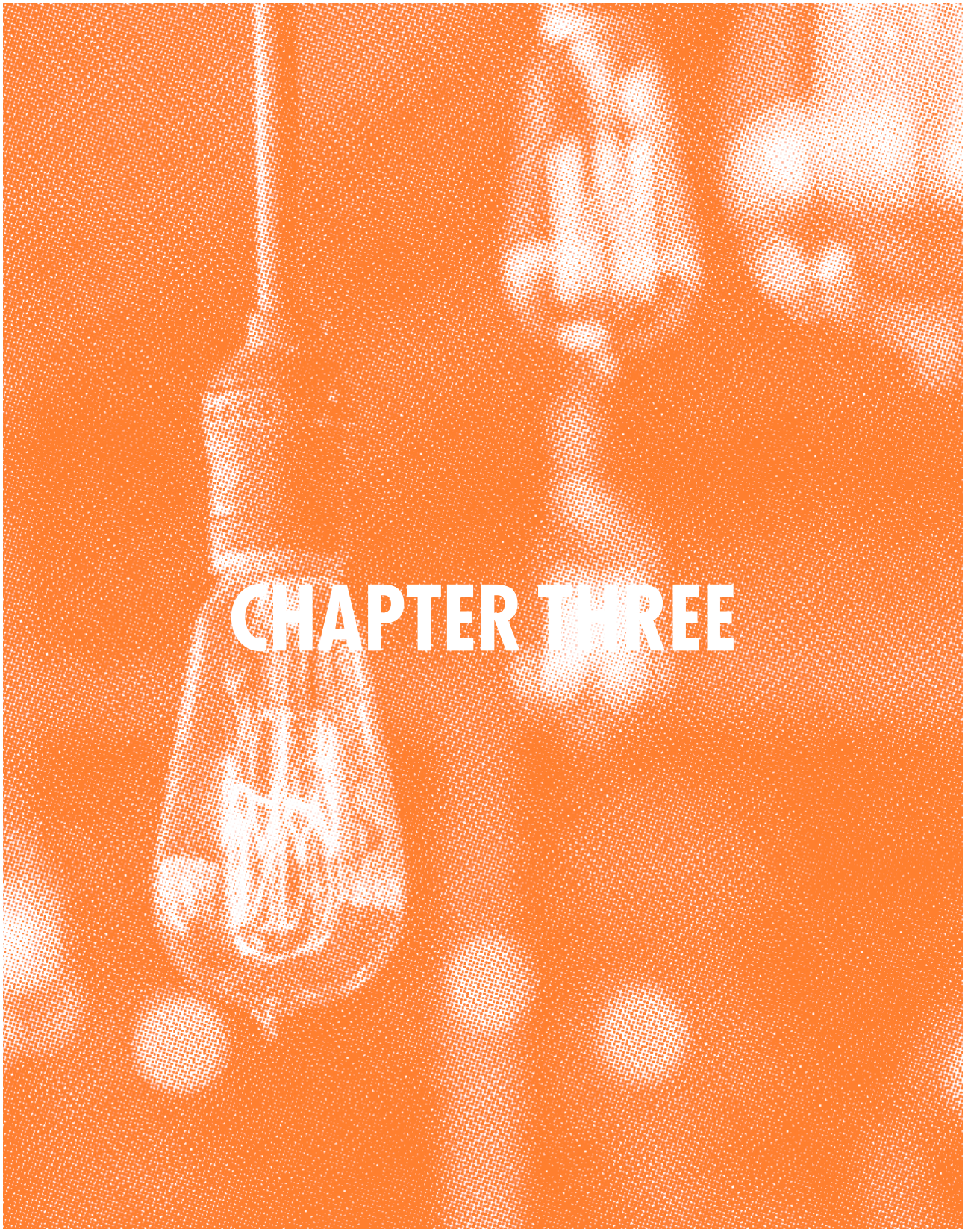
The evaluation criteria should explore whether;

- the use of research and analysis was thorough and applied in all circumstance;
- cost-benefit analyses informed all decision-making processes;
- all elements of the process included best practice risk identification, management and mitigation strategies;
- those working on the process were provided with benchmarks for success andunderstood these in priority order;
- the process included methods for identifying potential impacts on electricity prices and strategies to address these impacts;
- the process included a thorough analysis of social obligations and environmental considerations in the context of electricity networks;
- the process included frameworks to ensure neutral or positive impact on safety and service quality;
- the return on public assets in each supply area, including all transaction costs represented value for consumers in these areas;
- strategies to minimise post-lease costs being passed on to consumers were a feature of lease conditions and structure;
- the process mitigated all risk of costs being increased in the Essential Energy network as a result of it remaining the sole network under 100 per cent public ownership; and
- the risk allocation between the Government and the private sector is reasonable.

Recommendation 11: The NSW Government should commission the Auditor-General to evaluate the lease process and its outcomes once the lease is finalised.

The evaluation criteria should be set now to allow data collection to begin immediately and provide those working on the lease with an understanding of the criteria the success of the lease will be judged against.

The evaluation should explore the criteria noted above.



CHAPTER THREE

Privatisation & Price: Past Lessons

The NSW Government has rightly stated that network prices are set by the Australian Energy Regulator under a regulatory framework. This will not alter with any change of ownership. However, evidence from past privatisation processes demonstrate there is real potential for privatisation processes (rather than ownership per se) to have an impact on the prices paid by consumers—even years after the event. Past processes also show that this impact has the potential to last even after the proceeds of a sale or lease have been taken into account.

The privatisation processes discussed in this Chapter suggest that the lease should be structured in such a way as to limits any opportunity for change-of-ownership costs to be passed on to consumers—both now and in the future. If this does not occur, there is a very real risk of higher electricity prices eroding the value of the lease and placing an unfair and unavoidable burden on electricity consumers.

We urge the NSW Government to apply the lessons learnt from the processes discussed in this Chapter and to structure the lease in such a way that all costs are recognised as a cost of sale and are paid for at the time of the transaction.

3.1 Background

In 2011, the NSW Government privatised its three electricity retailers, Country Energy, Integral Energy and Energy Australia. The retailers retained the brand names under the sale while the network arms of these businesses remained under state-ownership with new names. The Energy Australia network became Ausgrid, the Integral Energy network became Endeavour Energy and the Country Energy distribution network business was rebranded as Essential Energy.

The process also involved the sale of the output of the Delta West and Eraring Electricity generators in early 2011. Under this arrangement, known as a Gentrader agreement, the State retained ownership of the generators, while Origin Limited bought the output of power stations at Eraring and Shoalhaven. TRUenergy Pty Ltd bought the output of Mt Piper and Wallerawang power stations.[50]

As a whole, the sale was found to be profitable. The sale of the retailers netted a $3.082 billion profit while the Gentrader arrangement resulted in a loss of $1.849 billion. The overall profit from the sale was $1.233 billion.[51] Collectively, the vendors in the retail sales (now stand-alone network businesses) retained $380 million for transaction-related expenses.[52]

50 NSW Auditor-General's Report Volume 4, 2011, Electricity Industry Overview, 7.
51 Ibid.
52 Ibid, 8.

3.2 Retailer Sale

Before the sale of the electricity retailers, Country Energy, Integral Energy and Energy Australia were state-owned corporations delivering retail and network services. The businesses operated these functions separately under ring-fencing arrangements. Ring fencing ensured that the costs of each business segment were transparently accounted for; and limited cross pollination of costs so pricing was based on the costs incurred by the services provided—whether regulated or unregulated.[53]

When the retail businesses were sold, the former owners (now stand-alone network businesses) assisted the new retail owners with short-term and long-term support. These arrangements were articulated through Transitional Service Agreements (TSAs). The length of TSAs differed for each transaction; for example, the TSA between Essential Energy and Origin Energy was scheduled to be in place for 43 months.[54]

The sale of the electricity retailers was the most profitable activity in the privatisation processes of 2011. As stated above, it realised over $3 billion dollars in profit for the state (albeit much of this offset the loss realised through the gentrader arrangement).

Yet, the costs of this sale still have the potential to impact on electricity prices today. As recently as June 2014, Ausgrid stated that the expected ending of the TSA between it and Energy Australia would result in $64.1 million worth of 'loss of synergy costs' over the period 2014-2019. According to Ausgrid, these synergies are derived from integrated operations between some network and unregulated operations.[55] Ausgrid will introduce efficiencies to reduce overall loss of synergy costs to $26.4 million with no impact after the 2016-2017 year.[56]

Endeavour Energy has outlined approximately $59.4 million of dis-synergy costs for the period between 2014 and 2019. However, efficiency programs have been introduced to offset these costs.[57] Similarly, Essential Energy has included $117 million against loss of synergies for the period from 2014-2019[58]—with all but $4 million of these cost offset by savings.[59]

Altogether, loss of synergy costs outlined currently in the three state-owned distribution networks' pricing proposals,[60] amount to over $200 million. Efficiencies to offset these costs result in the maximum potential impact being $30.4 million. However, if these costs had been funded from the proceeds of the sale, consumers may have seen potential cost reductions of almost $170 million in this regulatory period.

At the time of writing, the AER had not made its final determination on the distribution network's

53 Country Energy, Cost Allocation Method, 2008, 2, http://www.aer.gov.au/sites/default/files/Country%20Energy%20-%20public%20CAM%20(31%20March%202008).pdf
54 NSW Auditor General's Report, volume four 2011, Essential Energy, 53.
55Ausgrid's Regulatory Proposal, 2014, 50.
56 Ibid.
57 Endeavour Energy Regulatory Proposal – 1 July 2015 to 30 June 2019, 91 and 77.
58 Note that loss of synergy costs for Essential Energy also include costs arising from the sale of the Wagga Wagga gas network to Envestra. See page 76 of Essential Energy's Regulatory Proposal 2014.
59 Essential Energy, Essential Energy Regulatory Proposal 1 July 2014-30 June 2019, 2014, 77.
60 Note that these cost inputs are subject to approval by the Australian Energy Regulator—a process that is in train at the time of writing.

pricing proposals. Until this occurs it is not possible to determine the final impact loss of synergy costs will have on network prices. However, the mere fact that the networks proposed these costs suggests that these risks should be identified and managed as part of the lease process; it is not appropriate for the Government to rely on the AER to make this decision.

3.2.1 What can we learn from the sale of the NSW retailers?

The sale of the NSW electricity retailers shows that unless mechanisms exist to ensure costs arising from privatisation processes are funded by the proceeds of those transactions, there is the possibility that consumers will be exposed to the risk of increased prices in future years.

It is reasonable that the long-term lease of network businesses will result in costs, but these costs (including any potential for future costs) should be funded from the proceeds of the lease. In structuring the lease, the NSW Government should therefore ensure that the lease arrangements include provisions that protect consumers from bearing the financial risk of lease transaction costs both now and in the future. This may require a proportion of the lease proceeds to be held in trust until all transition conditions of the lease are fulfilled or until one full regulatory cycle is completed under new ownership arrangements.

This course of action will also be a strong incentive for effective management of the lease process to reduce the risk of such costs arising.

Recommendation 12: In order to ensure costs associated with the lease are not passed on to consumers, the NSW Government should:

a) require network businesses to report on potential cost impacts of the lease arrangements being considered so these costs can be minimised and/or recovered in lease transactions;

b) set the lease price inclusive of all transaction-related costs, or agrees to hold a proportion of the proceeds in trust for a full regulatory period to be drawn upon in the event of costs arising;

c) seek guidance from the AER about the potential for lease-related costs to be passed through to consumers under current regulatory arrangements and use this information to structure the lease in a way that minimises opportunities for pass throughs or increases to operating expenses;

d) factor the potential for future costs into equations when setting the retention value for the network assets;

e) analyse the costs, benefits and risks (including any potential impacts on electricity prices) of proposed lease arrangements for each distribution supply area. These analyses should be made public and subject to comment through a public consultation processes prior to any commitment being made;

f) Quarantine any costs generated by the lease of each network as a cost of sale that cannot become a feature of individual businesses' future regulatory proposals.

3.3 Sale of generation output

The 2011 sale of generation output was not a profit making exercise when viewed in isolation from the sale of the retailers. When reporting on the sale the NSW Auditor General stated that:

'The sale proceeds achieved were less than half the carrying value of the assets sold.'[61]

While this seems a relatively bleak outcome, the Special Commission of Inquiry into the Electricity Transactions found that the privatisation transactions overall represented value for money.[62]

The sale of the generation output was complex compared to the sale of the retailers. For example, the setting of a retention value was complicated by the fact that what was offered for sale (generation capacity only) differed from what would be retained (generator and generation capacity ownership) if the process failed to attract a certain price.[63]

The gentrader model was neither a sale of the generator or a long-term lease of the asset. Rather, the sale of the generator's output only meant there was a need for ongoing cooperation between the asset owner and the Gentrader who bought the right to trade the generator's output in the National Energy Market.[64] The Special Commission of Inquiry noted that this complexity:

'gives rise to an unquantifiable risk of disputes and litigation.'[65]

In the case of the Gentrader arrangements, further complexity resulted from the inclusion of Available Liquidity Damages (ALDs), which allowed the Gentrader to receive a fee where the generator did not achieve 'contracted availability targets.'[66] While these damages were subject to an annual cap; they have reached significant amounts. For example, Eraring Energy incurred 'net liquidated damages …of around $2 million in the period between 27 February 2011 and 30 June 2011.'[67] Most of the ALD costs were recouped from a NSW Government Fund set up for this purpose.[68]

3.3.1 What can we learn from the sale of the generation output?

The Gentrader arrangements provide an instructive cautionary tale for those considering the structure of the long-term lease of the electricity networks. The section below suggests some areas for Government consideration.

Strong governance is important

The governance arrangements for the networks under a 49 per cent lease have not yet been decided. It is also unclear whether possible governance models will be discussed publically before the NSW

61 NSW Auditor-General's Report Volume 4, 2011, Electricity Industry Overview, 8.
62 The Hon Brian Tamberlaine QC, Final Report of the Special Commission of Inquiry into the Electricity Transaction, 2011, 322, paragraph 196.
63 Ibid, xiv, paragraph 64.
64 Ibid, xv.
65 Ibid.
66 NSW Auditor-General's Report Volume 4, 2011,Eraring Energy, 47.
67 Ibid.
68 Ibid and The Hon Brian Tamberlaine QC, Final Report of the Special Commission of Inquiry into the Electricity Transaction, 2011, 93, paragraph 6.56.

Election. As discussed in Chapter 2, it is important that the lease facilitates a system of strong governance that maximises cooperation between the lease-holders and the Government owners in order to minimise the risk of litigation and disputes. Such events are unlikely to produce positive outcomes for consumers and could erode the benefit of the lease over the longer term.

Set a retention price per network

The Government has committed to setting a retention price under which the NSW network assets will not be leased.[69] It is important that each business being considered for lease has its own retention value and that that value takes full account of all cost impacts related to lease transactions. These costs should be quarantined as a cost of sale and not become a feature of individual businesses future regulatory proposals. If this were the case, it would be the consumers in the network supply area who would be contributing to these costs as an input to future network charges.

Don't maximise the lease price at the risk of introducing future costs

A higher lease price should not be derived on the basis of meeting certain demand forecasts or other outputs that could generate ongoing costs (akin to Availability Liquidity Damages) where these targets are not met. In the case of the Gentrader arrangements this resulted in ongoing liabilities for the NSW Government. For example, the NSW Government's 2014-15 Budget Papers acknowledged that:

'Over the course of 2013-14, all residual aspects of the electricity Gentrader arrangements were divested, saving the State an estimated $2 billion through avoided Availability Liquidated Damages liabilities over the life of the previous contracts , and the removal of the obligation to develop and operate a coal mine at Cobbora.'[70]

Be transparent about potential risks and benefits for consumers in each network area

When considering the lease of electricity distribution businesses in particular, it is important not to oversell the benefits to the whole state to the detriment of consumers of individual distribution network businesses.

The distribution network businesses operate in geographical regions—their costs are levied on the residents of those regions through electricity prices. There is already a large difference in the price paid for electricity by those in Sydney and those in Rural and Regional areas. For instance, the average annual bill for a person in Ausgrid's largely metropolitan supply area is $2106 while those in Essential Energy's supply area – which is largely rural – is $2725 per year.[71]

Should leasing arrangements benefit one business and not the other, the benefits of the lease will not be shared equitably across all electricity consumers. The same can be said if lease arrangements produce costs—such as the potential for loss of synergies as discussed above. This is a risk that should be managed in the structure of the lease and the setting of retention values. This situation also necessitates an analysis of costs, benefits and risks of proposed lease arrangements by distribution supply area.

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69 NSW Government, Keeping the lid on household costs, Media Release, 10 June 2014.
70 NSW Government, Budget Statement, Budget Paper Number 2, 2014-15, Chapter 9, 2014, 4.
71 AER, State of the Energy Market 2013, 129, based on 2013-14 average annual bill.

3.4 The sale of the NSW generators

When the Special Commission of Inquiry into the Electricity Transactions considered the costs, benefits, risks and liabilities of the gentrader agreements it noted the following;

'the execution of the agreements has entrenched an option that deprived the State of the opportunity of achieving maximum value from those of its generators that are subject to the gentrading agreements. Although the State (through the relevant SOC) retains a right to transfer the generator to a third party, it may be difficult to encourage entities other than the corresponding gentrader to bid for it. This may make it difficult to create the requisite competitive tension to achieve good value for the generators that are subject to gentrading agreements.'[72]

In August 2013, Origin Energy, the company that bought the generation output of Eraring and Shoalhaven Power Stations in the Gentrader transaction of 2011, bought these power stations for $50 million.[73]

Government Budget Papers noted:

'The sale of Eraring Energy to Origin Energy was finalised on 1 August 2013 at a net cost to the State of approximately $100 million, including a $300 million payment in respect of the Cobbora termination.'[74]

In September 2013, Delta Electricity's Mount Piper and Wallerawang power stations were bought by Energy Australia, the same entity[75] that bought the generation output of these stations in 2011. NSW Budget Papers reveal the net proceeds for this sale were $160 Million.[76]

3.4.1 What can be learned from the sale of the NSW generators?

It is beyond the scope of this Report to comment on the value for money realised from the sale of the NSW Generators. Experts would need to take a number of factors, including exposure to future liabilities, into consideration in order to do so.

This example simply shows that it was (as foreshadowed by the Special Commission's comments above) the companies that purchased the right to trade the generation output that bought the generators when they became available for sale. Further analysis of whether the Gentrader arrangements had an impact on the price these assets could attract would be useful in informing those who are developing the structure of the long-term lease arrangements for NSW networks.

Consider whether the lease will erode any future sale value for network assets

Prior to any long-term lease going ahead, the Government should strongly consider seeking independent expert advice on the potential for lease arrangements to have an impact on any future sale

72 Ibid, 224.
73 NSW Auditor General's Report to Parliament, vol 4, 2013, 41.
74 NSW Government, Budget Statement, Budget Paper Number 2, 2014-15, Chapter 9, 2014, 5.
75 The Generation output of Mount Piper and Wall W,
76 Ibid.

price of the state-owned networks and the ability to create the competitive tension needed to maximise that price.

This advice may also be valuable when the Governance structures for the partial privatisation are being developed. It is important that consumers benefit from strong governance arrangements at the same time as retaining maximum value for the assets owned by the State.

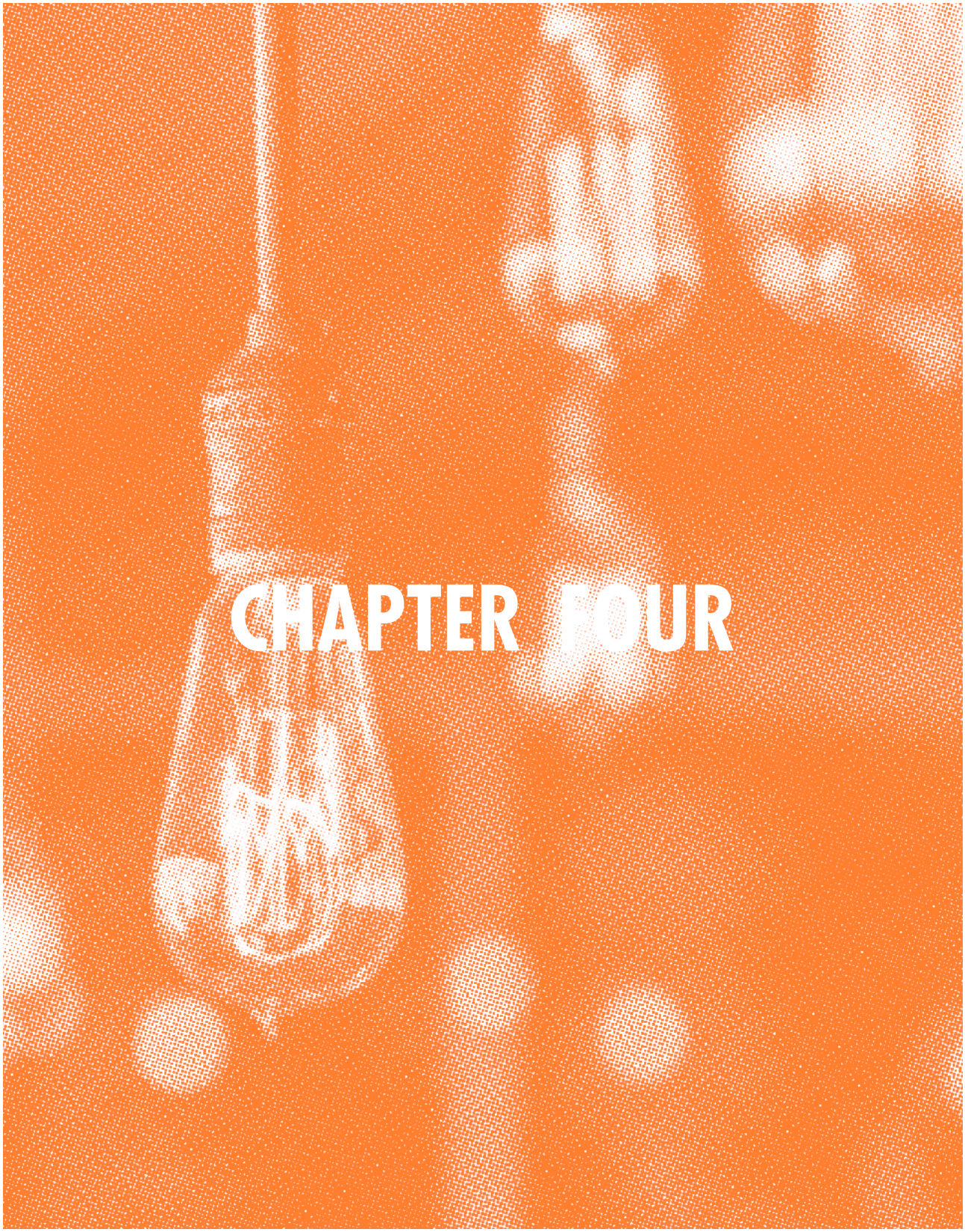
Make expert advice available to consumers to enable informed debate

The NSW Government has commissioned some very useful reports from a range of experts through the Rebuilding NSW consultation process and has made these reports available to the public. The commissioning and public release of expert advice in relation to issues raised in this Chapter would contribute to an informed debate about whether the long-term lease of the NSW Networks is in consumers' long-term interests.

Recommendation 13: The NSW Government should seek expert, independent advice on the potential for the long-term lease arrangements to impact (either positively or negatively) on any future sale price of the networks and/or the ability to create a competitive tension in any sale that may be considered in the future.

This advice should be informed by an analysis of whether (or how) the Gentrader arrangements affected the sale of the NSW Generators in 2013. The outcome of this analysis should be used to manage potential risks related to the long-term lease of the NSW Networks.

This advice should be publically released prior to any commitment being made to lease the networks.



CHAPTER FOUR

Privatisation: Ensuring The Benefits

Should the lease proceed, the NSW Government has committed to a 1 per cent discount from network prices until 2019,[77] which is when a new regulatory period begins. Taken on face value, this condition seems to offer a reasonable benefit for consumers. However, consumers need to understand how the Government will ensure consumers receive the full value of the discount throughout the supply chain from transmission, distribution and retail pricing stages.

There is no current system to ensure this discount is passed on to consumers. It would have to be outlined as a condition of the lease and a method to ensure compliance would have to be designed.

The question at hand is whether there will be any oversight to ensure that consumers receive the full value of this discount. Network pricing processes are complex and a range of inputs are considered in reaching a final determination.

4.1 Guaranteeing the application of the 1 per cent discount

Under current regulatory processes, the AER is setting network prices for the years 2015-2019 under a revenue cap. This means the AER works in accordance with the National Electricity Rules (NER) to forecast the revenues a business needs to cover its efficient costs and obtain a commercial return on capital.[78] Once the revenue allowance is determined, the networks must turn it into a tariff, or a price paid by customers.

The process for setting the price paid by customers is stipulated under the NER. For example, once the determination is made the distribution networks have 15 business days to supply a pricing proposal for the first regulatory year.[79] In subsequent years, the network must supply its proposal 2 months before the regulatory year begins.[80] The AER will review the proposal and if it complies with relevant sections of the NER, and if the AER determines that the forecasts used to generate the proposal are reasonable, it is approved.[81] The distribution network must publish price details on its website 20 business days before the regulatory period begins.[82]

To maximise transparency and ensure compliance with the Government's commitment to a 1 per cent discount from network prices, we believe the 1 per cent discount should be applied after the Australian Energy Regulator has approved annual network pricing proposals. This would ensure that consumers receive the discount from the efficient price set by the regulator in a public regulatory process.

Ensuring transmission price discounts are passed on to Essential Energy customers

The Government has committed to retaining 100 per cent ownership of Essential Energy. If Transgrid is leased, it is important that all consumers, including Essential Energy customers, receive the 1 per cent discount from transmission prices.

77 NSW Government, Rebuilding NSW Discussion Paper, 2014, 13.
78 Australian Energy Regulator, Our role in electricity networks and gas pipelines, web page accessed 31 October 2014, at http://www.aer.gov.au/networks-pipelines/our-role-in-networks.
79 - 82 ???

Ensuring the 1 per cent discount is permanent

It is also important to ensure that the discount applied in one year is quarantined and cannot be recovered in following years by inclusion in pass through applications, annual revenue cap reviews of unders and overs, yearly pricing proposals or regulatory proposals after 2019.

There is a need to work closely with the Australian Energy Regulator to devise a mechanism to manage this risk.

There may be an opportunity to learn from the experience of other jurisdictions about methods to manage this risk. Recently, Energex, a Queensland Government owned distribution network, responded to a ministerial direction not to pass on the full network costs allowed by the AER to retail customers on Tariff 11.[83] The costs of complying with this direction were considered forgone revenue and could not be recovered in future years.[84]

However, it will be harder to direct the Board of the partially leased businesses to forgo recovery of the 1 per discount if arrangements have not been made very clear as part of the terms of the lease.

Managing the risk that that consumers will not benefit fully from the 1 per cent discount

On 1 July 2014, the NSW Government removed the regulation of retail electricity prices. This means there is no current process that would enable the Government to ensure that retailers pass the 1 per cent discount on network prices on to consumers. Under retail price regulation, the public process for determining the regulated retail price would have facilitated scrutiny over whether or this has occurred. In a deregulated market, this is no longer possible.

The Discussion Paper notes the Government's expectation that electricity retailers will pass on the discount to consumers. The Government infers that competitive pressure will act as a motivator for this to occur. They state:

'If a retailer attempts to keep the 1% price discount, other retailers competing with them are perfectly placed to offer customers a better deal.'[85]

While competitive pressure may deliver the full benefit of the 1 per cent discount to consumers, there is no mechanism to ensure this is the case. The risk that the discount may not be passed on in full, or at all, should be considered. We note that when the carbon price was repealed, the Federal Government provided the Australian Competition and Consumer Commission (ACCC) with additional powers to monitor electricity prices and to act where businesses failed to pass on all of the relevant cost savings.[86]

Clearly the savings in this case are not of the same magnitude. However, the NSW Government has discussed the discount as a means to ensure immediate benefits to consumers from the time of the transaction.[87] Given the Government's intention to deliver a positive and immediate benefit to

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83 Energex, Statement of Corporate Intent 2012-2013, 2012, 25.
84 Ibid.
85 NSW Government, Rebuilding NSW Discussion Paper, 2014, 13.
86 ACCC, Our role in the carbon tax repeal, webpage, accessed 31 October 2014 at https://www.accc.gov.au/business/carbon-taxrepeal/our-role-in-carbon-tax-repeal.
87 NSW Government, Rebuilding NSW: Discussion Paper, 13.

consumers, it would be wise to consider ensuring this outcome through a coupling of oversight and competitive pressure.

We urge the Government to devise a mechanism that allows determination of whether consumers have received the benefit of the 1 per cent discount at both the retail and network pricing levels. We understand the costs of this mechanism need to be proportionate to the quantum of the discount. However, independent oversight and transparency are important in assessing whether the consumer benefits this condition seeks to achieve are fully realised.

Furthermore, consumers are being asked to provide a mandate for this lease. They are therefore entitled to know the extent to which the benefits promised have been delivered.

Recommendation 14: The NSW Government should develop a mechanism to ensure consumers receive the full benefit of the 1 per cent discount at both the retail and network pricing levels.

Recommendation 15: To maximise transparency and ensure compliance with the condition to offer a 1 per cent discount on network prices the discount should be applied after the Australian Energy Regulator has approved annual network pricing proposals.

4.2 Impact on future electricity costs

This Report has discussed the need to manage risks that may impact on future electricity prices. The current regulatory period is important in these considerations. However, it is also necessary to consider how the lease conditions themselves will impact future periods and whether costs that are held down by lease conditions in the 2014-2019 period will result in step changes after 2019. Loss of synergy costs discussed above are a good case in point regarding the potential for step changes.

4.2.1 Could the lease place future funding of energy rebates at risk?

The 2013-14 NSW Budget Papers noted that dividends expected from electricity distributors for the following three financial years would be used to:

'reduce electricity bills for those households eligible to receive the Low Income Household Rebate or Family Energy Rebate.'[88]

The Low Income Household Rebate is the primary energy rebate provided to eligible households in NSW. It presently allows low-income households to reduce their electricity bills by $235 per year. It is invaluable in assisting pensioners, veterans and health care card holders remain connected to an essential service.

If the Government is relying on dividends to fund these important rebates, the Government must identify an ongoing funding stream for these rebates when dividends paid to the State reduce as a result of leasing 49 per cent of the networks.

88 NSW Government, Budget Paper No 2, Chapter 9, 2013, 9.

The need for a long-term commitment on this issue has become even more important given the Commonwealth Government's decision to cut $1.3 billion of funding for concessions through the National Partnership Agreement on Certain Concessions for Pensioner Concession Card Holders and Seniors Card Holders in the 2014-2015 Budget.[89] While the NSW Government has committed to make up this shortfall for the current financial year[90], future funding arrangements are unclear.

While ownership may not impact electricity prices per se, unfunded energy rebates would have a large impact on consumers—especially those struggling to access this service because of low incomes or vulnerability. NSW Energy Rebates also include the Life Support Rebate and the Medical Energy Rebate. The consequences of these rebates being reduced or discontinued would be dire for people with disability and chronic illness.

The Government must assure the public that the lease will not affect the continuation of energy rebates in the short, medium or long term. If it is unable to maintain funding for these rebates due to a reduction of dividends or for any other reason, it should provide this information prior to the NSW Election so people can make an informed decision about whether to support the long-term lease of the networks.

Recommendation 16: The NSW Government should outline an ongoing funding stream for all energy rebates for the post lease period prior to the NSW Election.

4.2.2 Future-focused energy rebates

The two primary NSW energy rebates, the Low Income Household Rebate and the Family Energy Rebate are paid at a flat rate. The flat rate nature of these rebates fails to recognise the large differences in costs between network supply areas—especially between rural and metropolitan areas. (Nor do these rebates recognise that different types of households have different base energy needs).

Given the lease may affect consumers in individual networks in different ways, NCOSS believes that this period of change should include a shift to percentage-based energy rebates. This would ensure a more responsive rebate framework and would provide consumers with additional protection from any price fluctuations that may arise as a result of the leasing arrangements.

Concessions calculated as a percentage of the bill not only provide vulnerable customers with greater assurance that they will receive the support they need regardless of changes to pricing structures and overall costs, but also serve to better align the NSW Government's interests with those of low-income households. Everyone gains when energy bills are low, whether this is achieved by lower prices overall, through targeted energy efficiency programs, or by ensuring households receive the best deal possible for them. Given that take-up of the Family Energy Rebate has been low, we recommend merging this

89 Australian Government, Budget 2014-2015, Part 2: Expense Measures (Social Services), accessed on line 31 October 2014, http://www.budget.gov.au/2014-15/content/bp2/html/bp2_expense-21.htm
90 Liberal NSW, State Budget Protects Senior and Pensioners Concessions, 2014, accessed at https://www.nsw.liberal.org.au/news/statenews/state-budget-protects-senior-and-pensioner-concessions.

rebate with the Low Income Household Rebate to reduce administrative costs and better target rebates at those who are most vulnerable.

Recommendation 17: The NSW Government should replace the flat-rate Low Income Household Rebate and Family Energy Rebate with a percentage-based rebate targeted at low-income earners.

4.2.3 The importance of energy consumer advocacy

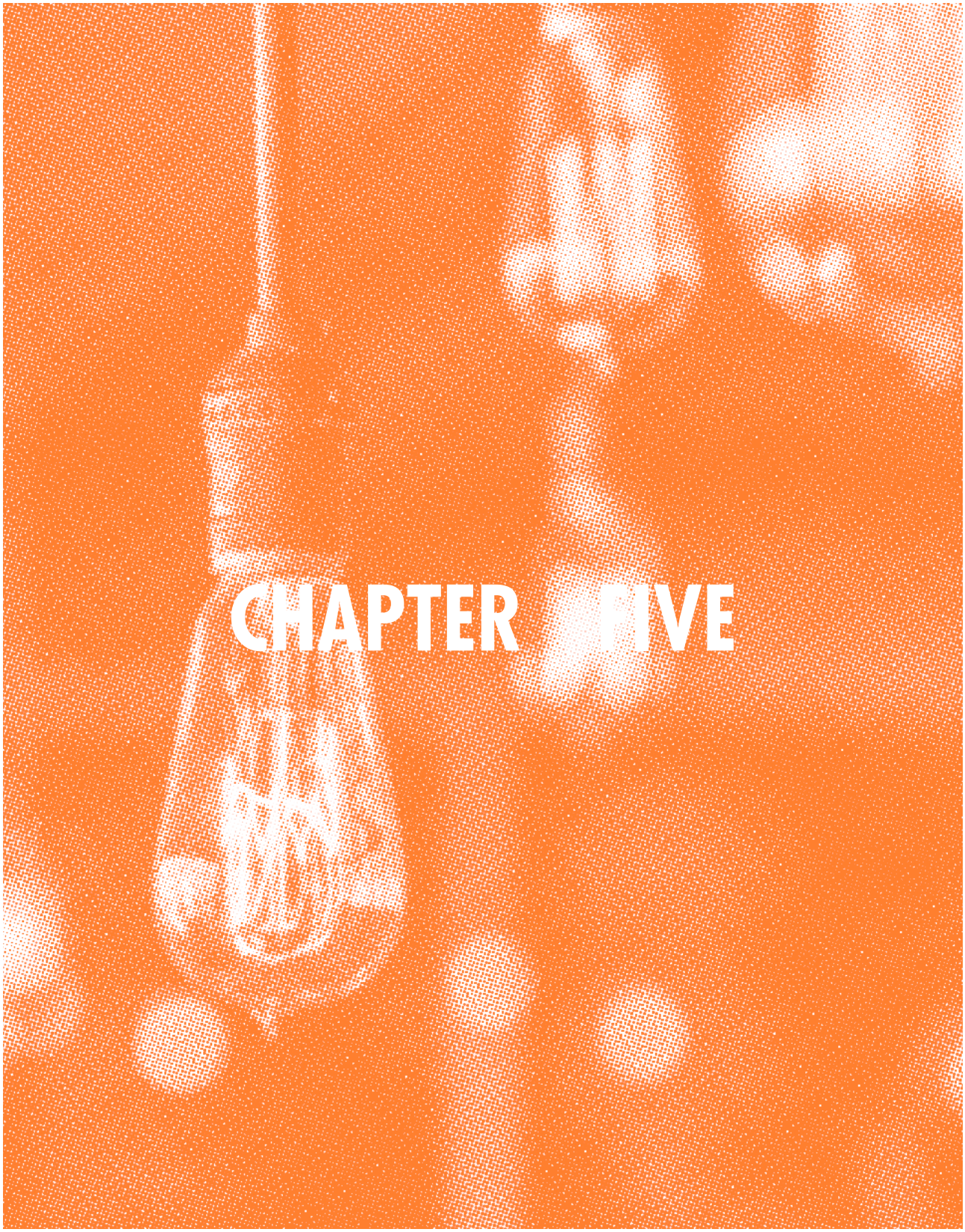
Given the lease will bring about changes to network ownership and management, NCOSS believes there is a need to ensure strong, well-resourced energy consumer advocacy that is NSW-focused.

In recent years there has been growing recognition of the importance of meaningful engagement with consumers and their advocates in ensuring better outcomes for energy consumers in policy and regulatory processes. Indeed, in response to criticisms of the regulatory process, the Australian Energy Regulator has led the Better Regulation Program through which they have developed a stronger consumer engagement framework and have established the Consumer Challenge Panel. Energy Ministers have similarly recognised the importance of consumer advocacy in agreeing to establish Energy Consumers Australia (ECA) – a body that will increase consumer advocacy on national energy market matters of strategic importance.

The recognition and subsequent resourcing of consumer advocacy at the National level is encouraging. However, we also see the need for NSW-focused advocacy that understands the environment and the process of change that will occur should the lease proceed.

We therefore recommend that ongoing funding for consumer advocacy at the NSW level forms part of the package of responses to the proposed part-lease of the electricity networks. We note that similar provisions were made during the reform of the Victorian energy market.

Recommendation 18: The NSW Government should provide additional resources for ongoing energy consumer advocacy to ensure energy consumers are strongly represented in processes related to the lease and in the post-lease environment.



CHAPTER FIVE

Addressing consumers' concerns: price

In the debate about privatisation or leasing of the networks, a number of themes consistently emerge that are in addition to the community's concerns about whether they will receive a fair return on the sale of their electricity networks. Electricity consumers also want to know:

• will privatisation lead to higher prices for the network services?

• will privatisation lead to a decline in the reliability and safety of the network?

The risks around getting fair value for the lease of the assets were discussed in Chapter 3 of this report and Chapter 4 touched briefly on the lease and electricity prices. In Chapters 5 and 6, this Report considers whether privatisation, per se, increases the risk of higher network prices to consumers and/or lower service standards. To address these questions, the report examines:

• the regulatory framework for determining network prices and reliability standards and targets; and

• information on the comparative prices and reliability of private and government owned networks in the National Energy Market (NEM).[91]

The examination of these two issues points to the importance of an effective regulatory framework and a strong, independent and well-resourced regulator in managing outcomes for consumers.

The Report, therefore, makes a number of recommendations about the actions the NSW Government should consider before proceeding with the lease in order to minimise risks around prices and reliability. Identifying gaps and addressing inefficient regulatory overlaps will provide benefits to both consumers and buyers of the assets. It will also lay a sound foundation for improving the efficiency of Essential Energy.

5.1 Network revenue and prices: how are they regulated?

The electricity distribution and transmission networks are natural monopolies. As such, it is appropriate that the network's pricing and service quality is subject to regulation. The regulation can take many forms. For example, it can be intrusive or light-handed; it can be co-operative or formal, even antagonistic. In the National Energy Market (NEM), the regulatory arrangements for network revenues and pricing sits somewhere between these extremes.

The regulation of network revenues and prices sat first with the state governments, reflecting the state-based ownership structures of the electricity networks. Following the economic and competition reforms of the 1990s, the responsibility for regulating network revenues and prices moved to independent state-based regulators. In NSW, this was the Independent Pricing and Regulatory Tribunal (IPART).

The move to IPART was the first step in making electricity network pricing outcomes more independent of the political process. The second step in the reform process was the move to a national regulator. This occurred around 1999 for the transmission companies who were subject to regulation

91 The NEM participants include NSW, Queensland, Victoria, South Australia and Tasmania.

by Australian Competition and Consumer Commission (ACCC) and the National Electricity Code. In 2005, the NEM states agreed to a national regulatory framework under the National Electricity Law (NEL). All NEM jurisdictions recognised the NEL in their own jurisdictional laws. While the NEL providing the overarching legal framework for the NEM, the detailed regulation of the networks was set out in the National Electricity Rules (NER). The Rules are made under the NEL and have the force of law.

The states also agreed to the establishment of the Australian Energy Market Commission (AEMC) and the Australian Energy Regulator (AER). The AEMC would be responsible for making the Rules and the AER would be responsible for applying the Rules. The Australian Competition Tribunal (ACT) was appointed under the NEL as the appeal body.

The NEL can only be amended by agreement of all the states through the Council of Australian Governments (COAG) and the COAG Energy Council (CEC), ensuring that there is a large degree of stability and certainty around its content.

However, any stakeholder, including the CEC and the AER, can propose an amendment to the NER. Irrespective of who proposes an amendment, the AEMC must go through an extended process of consultation before it can approve, amend or reject a Rule change proposal.

Notwithstanding the implementation of the national regulatory framework, agreed to by all the NEM states, each state has retained its own electricity law, regulations and codes. NSW, for instance, retains the Electricity Supply Act 1995 and IPART continues to have responsibility for administering licences and monitoring network performance.

In most instances, these laws and codes cover specific state issues; however, there remain areas of overlap between the state and national laws and rules. While network revenue determinations clearly sit with the national regulator, the regulation of reliability standards is spread across both jurisdictional and national regulators. This will be discussed further in Chapter 6, along with the implications of this for the privatisation process in NSW.

5.1.1 A national framework for network revenue regulation

This section describes the evolution of the national framework for regulating network prices. It also sets out the current state of play, as this is central to any discussion on whether privatisation, through sale or leasing of the networks, directly leads to increased risk that network prices will increase beyond their current high levels.

As noted above, the AER is the central body responsible for determining the revenue allowances for the electricity distribution and transmission networks in the NEM. The AER's revenue decisions are made subject to the laws and rules set out in the NEL and NER respectively.

With respect to the determination of network revenues and prices, the key elements of the NEL are:

- the National Electricity Objective (NEO) which states that the AER must regulate network revenues based on efficient costs and in the long-term interests of consumers in the price, quality, safety and reliability of the electricity supply;

• the Revenue and Pricing Principles (RPP) which set out the high-level matters that the AER must consider when making a revenue determination; and

• the functions and processes of the Australian Competition Tribunal (the Tribunal) as the court of appeal for an AER revenue determination.

The NER provides more detailed specifications on the processes and criteria that guide the AER in making its revenue and pricing determinations. They are set out in Chapters 6 (for distribution pricing) and 6A (transmission pricing) of the NER and include:

• the basic form that network pricing will take; in this case, either a cap on the total revenue (revenue cap) or a cap on the maximum average price (price cap);

• the approach to assessing the cost of capital; the Rules specify that the cost of capital must be based on a weighted average of the cost of equity and the cost of debt (WACC), expressed in nominal pre-tax terms;

• the criteria the AER must use in assessing the networks' proposals for capital expenditure and operating expenditure;

• a specific requirement that the cost of capital, capital expenditure and operating cost allowances must be based on the costs of a benchmark efficient entity with the same level of risks as the network service provider;

• the principles that the networks must apply when setting their network tariffs;[92] and

• the timetable and consultation requirements for the AER and the networks for both the revenue determinations and the network tariff approvals.

Importantly, neither the NEL nor the NER provide different requirements for government and private network businesses. The task for the AER under the NEL and NER is to assess the efficient costs of providing the network services (including a fair return on its investment in the network) where these costs are based on the costs of a "benchmark" efficient service provider.

If a network is inefficient and has high costs relative to the benchmark costs, then under this form of regulation, the shareholders, not the consumers, should pay the additional inefficient costs through lower profits and dividends. If the network business is very efficient (it beats the benchmark), then its owners have the opportunity to share in the additional profits, although the regulatory incentive schemes ensure that consumers share much of this saving over time.[93]

At least that is the theory.

In practice, since the move to the national regulatory framework, it would appear that networks have been able to achieve substantially higher revenues and higher profits than expected, along with

92 The Rules relating to how networs set their tariffs (given the AER's overall revenue allowance) are currently being amended by the AEMC in order to require networks to develop efficient tariffs that reflect the costs of supply to that tariff segment.
93 For example, the Efficiency Benefit Sharing System (EBSS) allows the network business to keep around 30% of the additional cost savings, with 70% returned to the consumers over time.

massively increased capital expenditures and increases in operating expenditures. This outcome has been particularly onerous for NSW and Queensland consumers, although consumers in other states have not been exempt from significant price increases. At the same time, energy use has been declining across the NEM and peak demand has not risen at the rate expected when the AER set the revenue allowances.

For NSW distribution and transmission networks, the AER made its first revenue determination in 2009 for the period 2009-10 to 2013-14 ("2009-14"). Even prior to that determination the networks had undertaken a significant expansion in their capital programs in anticipation of the move to national regulation. The AER's first determination saw further growth in capital and operating expenditure allowances, a higher cost of capital allowance and, therefore, significant revenue growth and price rises for NSW consumers. Figures 5 and 6 below illustrate the rapid growth in allowed revenues following the AER's 2009 revenue decisions.

It is not surprising that following the AER's first round of determinations for each of the NEM distribution and transmission network businesses, there were immediate calls for reform of the NER. These came not only from consumer representatives, but also from governments and the AER itself. The AER believed it was restricted in making the best decision on efficient network costs, including the cost of capital, by the NER.

In effect, the onus of proof was on the AER to disprove network expenditure proposals. In many cases when the AER did reject a network's proposal, the Tribunal overturned the AER's decision. Therefore, the AER's ability to exercise its judgement to set revenue outcomes that were in the long-term interests of consumers was considerably restricted – arguably more so than its jurisdictional predecessors such as IPART.

In 2012, after an extensive consultation process, the AEMC made some significant changes to the NER, designed to give a greater focus on the interests of consumers and provide for the AER to have greater discretion in how it made its decisions. Following the changes to the NER, and a 12-month consultation process, the AER published a suite of six Guidelines that (inter alia) set out how, and on what criteria, it will make its revenue determinations.

Parallel amendments were made to the NEL to reform the appeal processes and prioritise the long-term interests of consumers in the Tribunal's decisions.[94] The AER also progressed the development of its benchmarking capabilities to enable it to more critically assess network revenue proposals against the criteria of the "benchmark efficient network business".

It is yet to be seen if these reforms to the NER and the NEL, and the new benchmarking tools, will lead to better revenue and pricing outcomes for consumers. However, the AER has recently published its first draft decisions under the amended NER.[95] The draft decision indicates that the AER intends to adopt a more critical review of network proposals, using its new benchmarking tools, and capabilities in assessing the cost of capital, to make decisions in line with the NEO.

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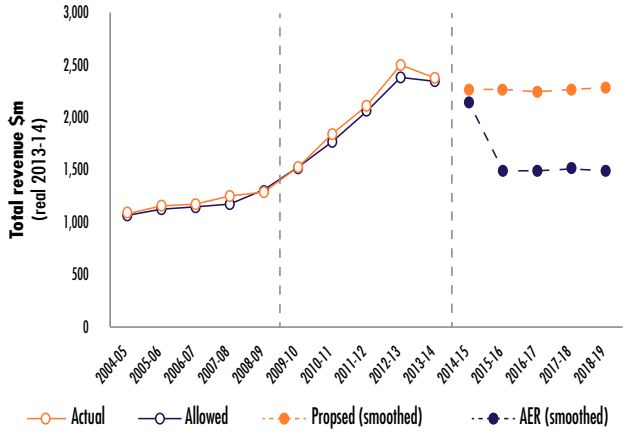
94 The reform of the Limited Merits Review regime was initiated and managed by the Standing Council of Energy Ministers (SCER – now the CEC), as it involved amendments to the NEL that all states would have to agree on.
95 The AER's Draft decision for 2015-16 to 2018-19 for Ausgrid, Endeavour Energy, Essential Energy and Transgid can be found on the AER website. http://www.aer.gov.au/networks-pipelines/determinations-and-access-arrangements

Figures 5 and 6 below illustrate both the escalation in revenue allowances in the previous regulatory period and the outcome from the AER's new approach under the revised NER.

Although the two charts set out the historical, proposed and allowed revenues for Ausgrid (distribution) and TransGrid (transmission) only, the AER's draft decisions for each of the other networks demonstrates similar reductions in the allowed revenue. The AER chair, Paula Conboy, for instance, states:[96]

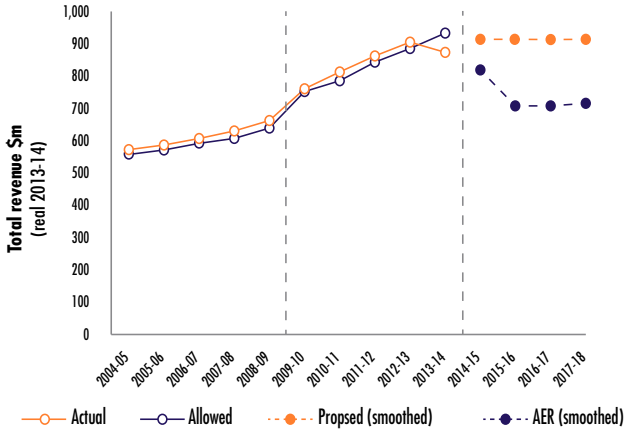
'We estimate that our draft decisions, if implemented, would reduce annual electricity bills for a typical residential household living in NSW, on average, by $219 (10 per cent) next year and by $360 for an average small business.'

Figure 6: AER's Draft Decision 2015 - 2019 – Ausgrid Revenue Allowance ($ million,2013-14)



Source: AER, Draft Decision Ausgrid distribution determination – Overview, November 2014, Figure 1-1, 10. The chart includes Ausgrid's transmission network .

Figure 7: AER's Draft Decision 2015 - 2019 – TransGrid's Revenue Allowance ($ million, 2013-14)



Source: AER, Draft Decision TransGrid transmission determination 2015-16 to 2017-18 – Overview, November 2014, Figure 1-1, 9.

96 Geoff Winestock, NSW power rip-off unplugged, Financial Review, 28 November, 2014, 1.

5.1.2 Influences on the regulatory determination processes

One concern with the national regulatory process for setting prices is that it may become remote from the people affected by its decisions. This is both a benefit and also (potentially) a problem for consumers.

In the past, when governments set electricity prices, they were perhaps overly sensitive to current political demands and/or the demands of particular sectors or regions. This may have been one factor in the under-investment in networks before the national competition reforms of the 1990s. Under-investment is clearly not an outcome that is in the long-term interests of consumers. The advent of the independent state or national regulator went some way to addressing the risks of short-term solutions and political influence.

However, it is also essential that the independent regulator does not make its pricing decisions without any regard to local circumstances. The NER specifically requires the AER to take into account jurisdictional requirements. For example, the AER must take into account the cost to networks of complying with the reliability standards in each jurisdiction or the bushfire protection standards (Victoria). Until recently, there have been large differences between these standards with very significant impacts on network costs, as discussed in Chapter 6.

Jurisdictional governments can also influence the national regulation of network revenue through their participation in COAG and the CEC. These bodies can initiate inquiries, amend the NEL, recommend rule changes to the AEMC and set policy directions (such as the move to cost-reflective network pricing and competitive metering services).

Expanding the opportunities for consumers to participate in the determination process was one of the AEMC's central reform objectives when it amended the Rules in 2012.

During a revenue determination process, there are now multiple opportunities for consumers to participate in the process, including participating in the networks' expanded consumer engagement processes. Similarly, the AER is required to seek feedback from all stakeholders on its Framework and Approach (F&A), the network's proposals and the AER's draft determination.

New consumer bodies such as the Consumer Challenge Panel (CCP), and Energy Consumer Australia (ECA)[97] provide further avenues for critical review and consumer advocacy on the network proposals and the AER's determinations.

Important features of these consultation processes are that they are transparent and publically available. There is a real emphasis on disclosing the maximum amount of information, whether it is information provided by the networks to support their revenue proposals, or stakeholders' responses to the AER's draft and final determinations.

These requirements for disclosure apply equally to private and government-owned networks.

The AER's Confidentiality Guideline serves to limit the extent to which networks can claim

97 The CCP was established by the AER at the end of 2013, the ECA is expected to commence work in early 2015.

"commercial-in-confidence" over their proposals. As a result, the opportunities for "behind closed doors" negotiations are significantly more limited.

5.2 Will the lease of the NSW network assets affect network prices?

We have highlighted above that the AER makes its decisions on network revenues by reference to the overarching national electricity objective, the revenue and pricing principles in the NEL and the requirements under the NER. The AER must also make its decision under the principles and processes it set out in the various Guidelines and other documents such as the AER's Framework and Approach decisions.[98]

The AER's decision-making process also involves extensive consultation with all stakeholders at every stage in the process, as noted above. Transparency, predictability and communication are key elements to the way the AER must conduct its determination processes.

The issue of who owns the networks is, therefore not a consideration for the AER. Its processes and decision-making frameworks are the same for the NSW, Queensland and Tasmanian networks as they are for the privatised Victorian and South Australian networks.

Given this background, it is not readily apparent how the proposed ownership changes or leasing arrangements will, per se, lead to higher prices.

Nevertheless, there have been a number of arguments put forward that ownership arrangements will affect revenue and pricing outcomes. For instance:

- Argument: Government-owned networks have access to a lower cost of capital through their state treasuries, and this should be reflected in a lower cost to consumers in NSW (and Queensland). Privatisation would remove this option.

Response: The AEMC has rejected proposals to amend the NER to reflect the different cost of capital between government-funded and privately-funded networks, and the AER is bound by these Rules. In other words, even if the NSW networks remain in government hands, the AER's revenue determinations will be based on commercial rates of return.

- Argument: If the State Government owns the assets it is more likely to be able to influence the AER's regulatory decisions in favour of consumers.

Response: If this were the case, it would fundamentally disrupt the model of determinations being made by an independent regulator. If governments were to over-ride the decision-making process of the independent regulator, the risks of unintended consequences would also increase and may result in a loss of confidence in the process by consumers and investors alike.

More generally, consumers may benefit if the state government no longer has mixed objectives. If the network is privately owned, then the state government's objectives are more clearly directed at the AER

98 The first step in the AER's process for setting the networks' revenue allowances is to publish a Framework and Approach (F&A) paper for each determination. The F&A paper sets out (inter alia) the form of control, classification of services and the incentive mechanisms that the AER will apply in its determination. The F&A for the NSW networks was published in March 2013, updated in January 2014.

determining an efficient price; it no longer has an incentive to maximise its profits from the network businesses.

Whether this principle still applies when the state government still owns one network and has part interest in the other networks remains to be seen.

> • Argument: If the Government owns the assets, then it can in principle, accept lower prices and an uncommercial profit that a private owner would not accept.

Response: The evidence in NSW and Queensland suggests that governments have been willing to accept higher electricity prices and use the increase in profits for other purposes. In NSW, for instance, the dividends and tax equivalent payments to the NSW Government peaked in 2012-13 at some $1,712 million dollars (for the three distribution networks and Transgrid).[99] In 2008-09, the year just prior to the start of the 2009 – 2014 regulatory period, the total payment of dividends and tax equivalents was $670 million.[100] These increases in profits and the payments to government were largely attributed to the increases in the networks' allowable revenues.[101]

> • Argument: It might be expected that a Government-owned asset (albeit corporatised) could achieve greater efficiencies through its scale and purchasing power.

Response: The benchmarking evidence to date suggests that this is not necessarily the case; the private sector networks appear to be more efficient and demonstrated greater labour and capital productivity, taking into account the different environments in which each network operates.

Figure 7, taken from the AER's November 2014 distribution benchmarking report,[102] illustrates this point using a total factor productivity[103] measure. Other productivity measures provided in the AER's benchmarking report also support the AER's conclusion that, to date, the privatised networks in Victoria and South Australia are "performing the most favourably".[104] Chapter 6 of this report will examine whether this has come at the cost of reliability. The productivity of all the networks is affected by the decline in "outputs" (i.e. demand) relative to the inputs (i.e. capital and operating expenses).

In the long term, improved productivity (whether by private or government networks) should lead to network prices that reflect the efficient cost of financing the business and developing and maintaining the network.

However, it seems that both the government and privately owned networks have strong motivations to increase revenues from their networks. In this report, we contend therefore that privatisation, per se, is not the threat to future prices. What is critical in either circumstance is that there is an effective rules

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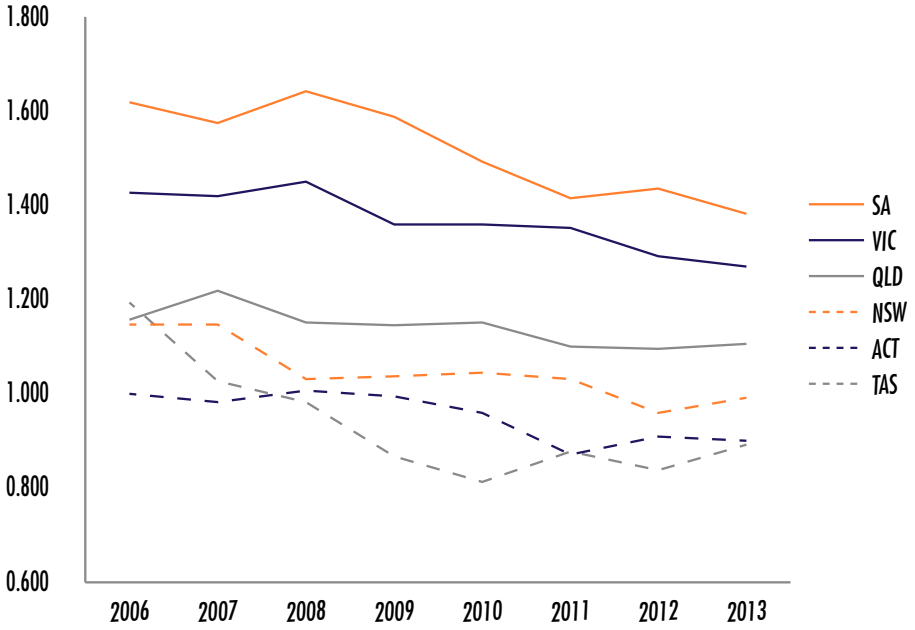
99 Source: NSW 2014-15 Budget Papers, Budget Statement 2, Table 9.1, 9-11.
100 See: NSW Government Industry & Investment, NSW Electricity Network and Prices Inquiry, Final Report, December 2010, Table 4.1,
24. The figures exclude Government guarantee fee which was expected to rise to $352 million in 2012-13, over six times the fee in 2008-09 ($56 million).
http://www.dpc.nsw.gov.au/__data/assets/pdf_file/0005/118904/NSW_Electricity_Network_and_Prices_Inquiry_Report.pdf
101 Ibid.
102 AER, Electricity distribution network service providers, Annual benchmarking report, November 2014.
http://www.aer.gov.au/node/25078
103 Total factor productivity measures the efficiency of both capital and operating costs.
104 Ibid, 29.

framework in place and an independent, strong and well-resourced regulator to enforce these rules in the long-term interests of consumers.

Figure 8: State wide multilateral total factor productivity 2006 - 2013



Source: AER, Electricity distribution network service providers, Annual benchmarking report, November 2014, Figure 17, 32.

5.2.1 What is the role of the NSW Government in future revenue determinations?

As stated above, if the Government does not own the assets then in principle it cannot influence the networks' pricing proposals' as it can through triggers discussed previously in the State-owned Corporations Act. This is the role of the independent regulator and this report highlights the importance of ensuring effective Rules and a regulator that is independent, strong and well-resourced. Without these features, a regulator will find it difficult to resist the pressures of the networks, particularly as the networks appear to have substantial resources to press their cases for higher revenues and prices. Government ownership has not stopped electricity networks strongly pursuing their case.

For example, in their revenue proposals submitted to the AER in May 2014, the NSW networks submitted many, many pages of material and funded multiple reports from various experts to support their case for additional revenue allowances.[105] This approach could potentially discourage ordinary consumers from having meaningful engagement in the process—even though they are vitally affected by the outcomes of the AER's decision.

This experience points to a number of ways in which the NSW Government can support the regulatory process and thereby support the principle of constraining network prices to efficient levels, quite

105 Unfortunately the regulatory regime does not provide for a cap on expenditures on these regulatory proposals and therefore, the costs are generally passed on to consumers. This includes the cost of appeals to the Tribunal.

separately from its plans for future ownership changes.

The points below provide some possible actions the NSW Government could take. No doubt there are others. The most important point is that, as part of the privatisation or leasing process, the NSW Government should include considerations of how it can support or improve the regulatory processes, with the aim of ensuring NSW electricity consumers are subject to only efficient pricing outcomes from the regulatory process.

5.2.2 The NSW Government's commitments on network pricing

In response to community concerns, the NSW Government has already made a number of commitments regarding network prices over the next four years (to the end of the current regulatory period in 2018-19). They include the two commitments identified in Chapters 1 and 4 of this report:

- the leased companies will deduct 1 per cent from their network tariffs for the next four years (2015/16- 2018/19); and
- the Government expects the networks' 2015-2019 revenue proposals to the AER for the transition year (2014-15) and for the remainder of the regulatory period (2015-19) to limit increases in network prices to CPI or less.

Both these commitments would appear to directly benefit NSW electricity consumers.

However, they also raise some significant issues that may impact on the confidence of any potential parties seeking to lease the assets. In addition, intervention in pricing can result in unintended consequences and complexity.

The 1 per cent tariff reduction

The potential issues arising from the NSW Government's commitment to deduct 1 per cent from the network tariffs for the next four years were highlighted in Chapter 4 of this report.

The concerns largely revolve around the details of how this commitment can be implemented and how the NSW Government can ensure that the networks do not "claw back" some or all of these savings in future regulatory periods. The report also seeks advice on how consumers can be confident that retailers do in fact pass on the savings in network prices to consumers. It would be a rather futile gesture by the NSW Government if the reductions in network prices simply provide additional profits to the retailers and little or no benefit to consumers.

Moreover, the implementation complexities of an imposed network tariff reduction in the context of a "revenue cap" form of regulatory control should not be under-estimated. Under a revenue cap form of control, the AER effectively operates an "under and overs" account – when a network under-recovers its allowed revenue in one year, it can (usually with a two year lag) recover it in future years. The reverse occurs if the network over-recovers. The State Government will need to work with the AER to ensure that the 1 per cent discount sits outside this process.

The CPI cap

In some ways, however, the NSW Government's request to the networks to restrain their proposed revenues and price increases to CPI poses even more complex issues as it goes to the heart of the incentive based regulatory arrangements.

Recommendation 19: The NSW Government should demonstrate its commitment to a strong, well-resourced and independent regulator both directly, and through its leadership in COAG and the COAG Energy Council (CEC).

In establishing Networks NSW, comprising the three NSW distribution companies, the then Minister for Energy, stated that:[106]

'Our immediate goal is to contain increases in the network costs to no more than CPI over the next six years while maintaining a safe and reliable network.'

In the subsequent revenue proposals by the NSW distribution and transmission networks, the networks have stressed their compliance with this directive. For instance, Ausgrid states in its May 2014 regulatory proposal:[107]

'Together our carefully prioritised and streamlined program [as set out in its revenue proposal to the AER] has assisted us to meet our goal of striving to contain average increases in our share of customers' electricity bills at or below CPI.'

For consumers this may seem to provide some long awaited relief to the double digit network price increases of the past. However, the networks' revenue proposals suggest that the CPI served less as a constraint and more as a target. That is, the networks appear to have overlooked the opportunity for a more vigorous search for savings in expenditure.

More disappointingly, they have chosen to by-pass the AER's Guidelines, and in particular, the AER's Rate of Return Guideline. The networks have all proposed a cost of capital that is higher by a considerable margin than would be expected if the networks had adopted the AER's Rate of Return Guideline.

Moreover, encouragement by the Minister to cap prices at or below CPI, ignores the carefully designed interaction between the various regulatory components of incentive mechanisms, revenue allowances and service outcomes. It also has the potential to expose the networks to significant risk in the event, for instance, that energy use falls below the forecast levels in the regulatory determination.[108]

106 Media release from the then Energy Minister, Chris Hartcher, on the appointment of Mr Vince Graham as CEO of Networks NSW. http://www.endeavourenergy.com.au/wps/wcm/connect/ee/nsw/nsw+homepage/aboutusnav/media+centre/media+releases/2012/vince+graham+appointed+ceo+of+networks+nsw

107 Ausgrid, Regulatory Proposal, 1 July 2014 to 30 June 2019, 30 May 2014, 35. http://www.aer.gov.au/sites/default/files/Ausgrid%20-%20Regulatory%20Proposal%20-%20May%202014.pdf

108 The total revenue allowance includes an assumption about future energy use over the regulatory period. This will always be wrong, andthe revenue cap mechanism of "unders and overs" is designed to protect networks (who have substantial fixed costs) from excess exposure to variations in energy use. A commitment to a cap of CPI might limit this self correcting mechanism – although the networks have been careful to qualify their pricing proposals by reference to the dependence of the CPI price path on the demand forec ast accuracy.

Further unintended difficulties arise, given that the regulatory arrangements allow a "pass through" of unexpected costs, including transmission cost increases. Nor is it easy to see how a cap would work with the new "contingency projects"[109] arrangement in the NER or with emerging policy issues such as the potential roll-out of smart meters and smart grid. Of course, the Minister might allow exceptions for these factors, but politically this can be difficult to explain.

Given these potential complexities, it is critical that the NSW Government explain how these existing commitments will work in a practical sense, particularly if the Government proceeds with the leasing of the networks. It is, in our view, much more difficult to resolve these matters once there is a mixture of ownership and governance arrangements.

For these reasons, we also strongly recommend against the NSW Government making further pricing commitments. While such commitments may provide short-term "comfort" to consumers, they create longer-term difficulties and impact in unexpected ways with the independent regulatory framework.

The issue of how network prices can be constrained in the future is much better addressed by working with the businesses and the regulator to ensure only efficient costs are proposed by the networks and approved by the regulator.

In addition, once private ownership or leasing is in place, the network revenue allowances should be left to the decisions of the independent regulator, the AER, who in turn conducts a transparent and consultative process.

This is why it is so important that the NSW Government support the resourcing of the regulator, the continued reform of the Rules. However, if the NSW Government is not satisfied with the processes the AER must follow according to the Rules, then they have opportunities through COAG and CEC to promote appropriate changes to the NEL and NER.

5.2.3 The current regulatory review process

The first challenge the NSW Government faces in demonstrating its commitment to an independent pricing assessment process will be the AER's decision on the revenue allowances for Ausgrid, Endeavour Energy, Essential Energy and Transgrid.

The AER's Draft Decision was issued on 27 November, 2014. The Draft Decision has already demonstrated the AER's commitment to ensuring consumers pay no more than efficient costs for the network services. The Draft Decision proposes to make a significant reduction in allowed revenues compared to the networks' historical and proposed revenues.

Two examples of the AER's strong decision are illustrated in Figure 6 and 7 above.

The reductions in the revenue allowance (relative to the network's proposals) include across the board

109 The 2012 amendments to the NER included an allowance for contingency projects for distribution businesses. These have previously been allowed for transmission businesses only. It applies only to substantial projects (such as a sub-station replacement) but nevertheless it provides a mechanism whereby if a capital expenditure proposal may be needed, but it depends on factors such as load growth in an area (for example), the network can seek an additional allowance during the regulatory period – providing it is identified in the network's proposal as a contingency project. It is intended that this will reduce the need for networks to overs-specify their capital investment requirements at the start.

cuts in capital expenditure, operating expenditure, the cost of capital and the net tax allowance to levels that the AER considers represent the costs of an efficient benchmark network service provider. Total revenue allowances have reverted back to around where they were (in real dollar terms) at the start of the previous regulatory period. Given total demand has also fallen, this suggests that average prices will decline to around 2009-10 levels (in real dollar terms; nominal prices will be higher).

Recommendation 20: Prior to the lease of the network assets, the NSW Government should clarify its statements with respect to constraints on network revenues and pricing. This includes clarification of how the 1 per cent reduction and the 'CPI cap' will operate within the AER's incentive-based revenue control mechanisms.

Recommendation 21: The NSW Government should work with the AER to determine the most effective way of implementing its tariff-related proposals while maintaining the integrity of the regulatory framework.

Recommendation 22: The NSW Government should avoid further public commitments to network price adjustments or controls, emphasising its confidence in the decisions of the independent regulator and the regulatory process.

It is yet to be seen how this Draft Decision (if replicated in the Final Decision) might impact on the value of the leases to the Government—especially given the potential for a reduction in forecast cash flows. The test now for the NSW Government is how to respond to this. For example:

- should the NSW Government step back and let the matter be resolved between the networks, the AER and the electricity consumers?
- should the Government support a transitional approach, to allow the network businesses time to adjust while consumers bear continued high prices?
- should the Government "reject" the AER's decision and encourage the networks to submit a revised proposal that is similar to their original proposal?
- If the AER's Final Determination is little changed, should the Government encourage the networks to pursue an appeal to the Tribunal?

To undertake an appeal against the AER's Final Decision may be very costly to the networks[110] and will also create a great deal of uncertainty for consumers and for prospective buyers of the assets. It is likely that a future buyer would discount the value of the business if there were uncertainties around the outcome of an appeal.

We therefore recommend that the Government adopt the first approach. That is, the Government should allow the independent regulatory process to takes its course and actively discourage the NSW networks from appealing the AER's final decision (absent some clear error).

In the meantime, we suggest that the focus of the Government's and the networks' efforts should

110 Under the 2013 amendments to the NEL, the networks are not allowed to pass on the costs of an appeal to consumers. Previously costs could be passed onto consumers (irrespective of whether the appeal was accepted by the Tribunal, and consumers who attempted to oppose the appeal had the threat of costs imposed on them. The revised NEL explicitly removes this option.

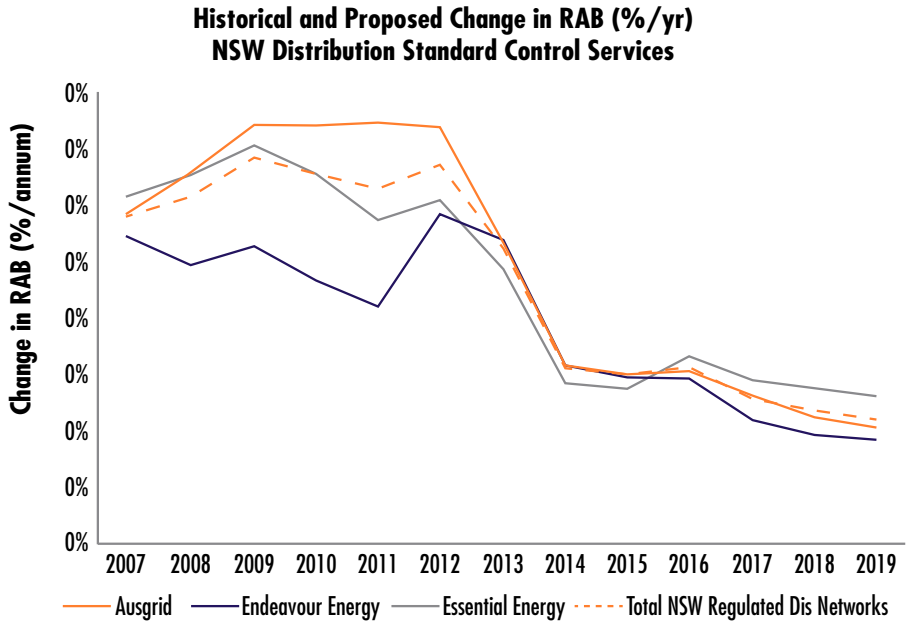
be less on the detailed regulatory debate and more on a vigorous pursuit of further savings and reprioritisation in both operating and capital expenditure. It is as important for Essential Energy as it is for the other networks that may be leased, that additional efficiencies are found.

The importance of vigorously pursuing further savings in expenditures is demonstrated in the outcomes of the May 2014 regulatory proposals (May, 2014). For example, under the networks' expenditure proposals, the regulated asset base (RAB) of each of the distribution businesses will continue to increase at a rate of around 5 per cent per annum, almost double the projected inflation rate.

This 5 per cent growth comes off the back of an annual average growth rate of 12 per cent per annum (across the three networks) driven by the surge in capital investment in the previous regulatory period. Figure 9 illustrates the historical RAB growth rate, and the future growth rate based on the networks' proposals. Given falling energy use, much of this additional asset capacity is not utilised.

Further growth in the RAB must be stopped if prices are to be stabilised and a spiral of lower demand and rising prices avoided. The prospect of this spiral is one that will add to a prospective buyer's perception of risk in the investment, so there is benefit to the NSW Government in proactively managing this issue.

Figure 9: Historical and proposed growth rate in the RAB (% growth/year, nominal)



Source: Calculated from Economic Benchmarking RIN provided by the distribution businesses to the AER covering the period 2006-07 to 2012-13.

Recommendation 23: The NSW Government should urge its networks to submit final revised revenue proposals to the AER that reflect a deeper commitment to achieving operating and capital expenditure efficiencies and to propose a cost of capital that is in line with the AER's Rate of Return Guideline. Controlling growth in the RAB should be a priority given excess capacity.

Recommendation 24: The NSW Government should advise its networks, prior to the lease, that it will be reticent to support merits appeal to the AER's decisions, thereby avoiding the uncertainty that such challenges would create.

Recommendation 25: The NSW Government, prior to the lease, should clarify its approach to ensuring that Government ownership of Essential Energy is not a barrier to Essential Energy achieving the same level of efficiency improvements as that expected from the other networks subject to private investment.

5.3 Other Energy Market policy issues

There are a number of other important developments in national energy policy that may have relevance to the NSW networks at this important time in their evolution.

It would be beneficial to consumers and potential buyers of the networks if the NSW Government was able to set out its policy positions on these issues prior to the lease of the network assets. It may be considerably more difficult to implement the required changes after the lease.

Examples of these policy issues are summarised below, noting that each of these has implications for future network revenue requirements or network pricing arrangements. They include:

- The AEMC has completed its review of distribution network pricing arrangements and the NER will be amended from 1 December 2014.[111] The new Rules will require regulated distribution companies to structure their prices to better reflect the cost of providing electricity to consumers with different patterns of consumption. The AEMC Chairman states that: "network prices are likely to be lower in the long-run with costreflective prices".[112]

While these changes will not alter the AER's approach to approving an overall revenue allowance, they do have implications for individual customer segments and individual network tariffs. There will be winners and losers.

If the NSW Government has concerns about the potential impact of these tariff changes, it would be beneficial if these were set out prior to the lease of the network assets.

COAG has adopted a policy of supporting the competitive roll out of smart meters in response to the AEMC's Power of Choice recommendations. At the request of SCER, the AEMC commenced a rule

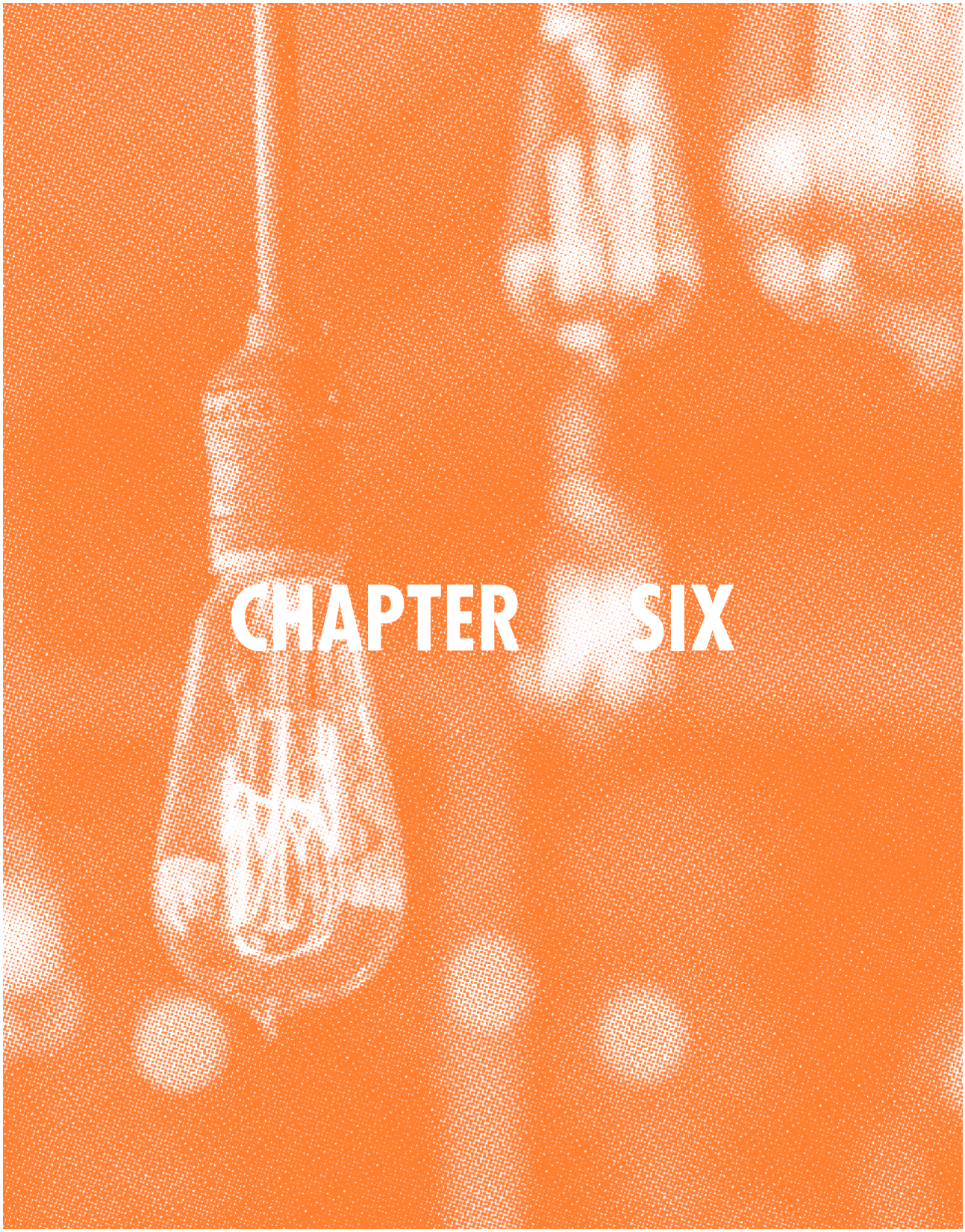
111 AEMC 2014, Distribution Network Pricing Arrangements, Rule Determination, 27 November, 2014, Sydney. http://www.aemc.gov.au/Rule-Changes/Distribution-Network-Pricing-Arrangements/Final/AEMC-Documents/Final-determination.aspx
112 Mr John Pierce, "New rules for cost-reflective network prices", 27 November, 2014. http://www.aemc.gov.au/News-Center/What-sNew/Announcements/New-rules-for-cost-reflective-network-prices

change process to enable competition in metering and related services in the NEM.[113] The AEMC has now issued a draft timetable for implementation of the changes, commencing in December 2014 and continuing through to 2016.[114] The NSW Government has recently indicated its policy support for a market-led rollout of smart meters.[115]

- Similarly, the NSW Government will need to decide its policy position on the implementation of the findings of the recently completed "Smart Grid, Smart City" led by Ausgrid.[116] Again, it would be beneficial for the NSW Government to indicate its high-level policy position on the rollout of smart grid technology prior to the sale or lease of the network assets.

Recommendation 26: Prior to the lease of the distribution network assets the NSW Government should provide some certainty to both consumers and buyers on its policy positions with respect to the implementation of the new network tariff arrangements and future investment in smart grid technology.

113 See: AEMC 2014, Expanding competition in metering and related services in the National Electricity Market, Consultation Paper, 17 April 2014, Sydney.http://www.aemc.gov.au/getattachment/5ffb9157-d7fa-4311-93b5-ab04b59007ce/ERC0169-Consultation-paperFINAL-for-publication.aspx
114 AEMC, Power of choice: enabling metering technology reforms, 20 November, 2014.http://www.aemc.gov.au/getattachment/2a710e3d-1b14-4f77-aebe--49983ab73c4b/Information-sheet-–-consultation-on-implementation.aspx
115 See, http://www.resourcesandenergy.nsw.gov.au/__data/assets/pdf_file/0017/533303/281014_NSW_gets-smart-about-meters.pdf
116 For details of the program see http://www.smartgridsmartcity.com.au



CHAPTER SIX

Addressing consumers' concerns: reliability and safety

This Chapter will:

- Set out in broad terms the main regulatory framework applying to the reliability of the network services; and
- Consider the empirical evidence regarding the performance of privatised and government businesses on reliability measures and investigate if and how reliability performance has changed in the decade following the full sale of the networks in Victoria.

Safety standards will also briefly be touched on in this Chapter. We recognise that the safety of employees, contractors and the public is a core requirement of the network businesses.

However, given the complexity of the layers of regulation on health and safety, and the different ways in which this is measured, we believe that the issue of the potential impact of the leasing of the assets on safety management and outcomes warrants a separate more detailed investigation that is beyond the scope of this Report.

6.1 Network reliability standards and targets: how are they regulated?

Network reliability refers to the extent to which there is continuity of supply to electricity consumers or, more particularly, whether electricity supply is available when sought by the customer. The regulation of reliability can be managed in a number of different ways and these methods have various impacts on the costs of providing network services.

The regulation of network service reliability generally involves three separate, but interrelated decisions:

- what is the best way to ensure adequate reliability is delivered?
- what are the best measures to assess whether reliability is delivered? and
- what targets should be set on those measures?

For instance, the regulator could decide that it is very important to minimise the number of times a consumers' electricity service is interrupted. High levels of interruption would indicate that some areas of the network need replacement or maintenance.

Should the regulator specify the design criteria that the network should build to (an input measure, sometimes called a "deterministic" measure), or should the regulator just focus on the outputs (such as minutes off supply), as this is what electricity consumers' experience.

The regulator would then need to decide what is the best measure of this (the standard) and what target should be set on that measure (the target). A target of zero interruptions in a year would be highly expensive; a target of 100 interruptions may cause a lot of consumer dissatisfaction. The answer to that question is not easy. It requires the regulator – and consumers - to assess the costs and benefits of different targets, and this may differ from one area to another, or from one type of consumer to another.

It is little wonder that there has been much talk and many studies, but rather slow action, to define the most efficient approach, establish the most appropriate standards and set the optimal targets. Under the direction of COAG and the Standing Council on Energy and Resources (SCER (now the CEC)), the AEMC has conducted a number of important studies to try to establish some common view across states in the NEM on what standards should apply, how they should be defined, and how targets should be established (not what those targets should be set at in a given jurisdiction). It is perhaps not surprising that the AEMC stated in its recent report on distribution reliability measures: [117]

'The Australian Energy Regulator (AER) and each jurisdiction define how distribution reliability should be measured in the NEM. This means different approaches are often used, making it difficult to compare performance across networks and increasing the regulatory burden for distribution businesses.'

In this Report we suggest that the NSW Government should first state clearly its policy position on these issues prior to the leasing of the assets. Second, the NSW Government will be best served by taking a leadership role in COAG and the CEC on the issues and recommendations raised by the AEMC in their various reports. Getting reliability "right" is important from the perspective of the both the networks and consumers. Getting a workable national reliability framework provides additional benefits, giving certainty and reduced costs to the buyers (and to Essential Energy) and allowing effective benchmarking of the performance of each network with its peers.

Recommendation 27: The NSW Government should clarify its position on the national reliability standards and target setting approach prior to the lease of the assets, as this provides certainty to buyers of any future commitments, and comfort to consumers that the Government is focused on best practice outcomes in the regulation of network reliability.

Recommendation 28: The NSW Government should take a leadership role in COAG and CEC to ensure that the extensive and extended investigation into national network reliability standards and targets comes to a satisfactory conclusion for the long-term benefit of electricity consumers in NSW. The certainty and transparency that this provides will reduce risk for consumers and the new investors in the networks businesses alike.

6.1.1 The regulation of reliability standards & targets in NSW

Prior to 2005, network design, reliability standards and targets, and reporting was solely the responsibility of the distribution businesses, subject to a number of codes and Australian Standards on electrical installations, electrical equipment and the like.

In 2005, however, the NSW Government imposed new licence conditions that were further updated in 2007.[118] The new licence conditions set out quite specific standards for the design of the networks as well as a range of output standards to measure reliability and performance. The changes to the licence

117 AEMC 2014, Review of Distribution Reliability Measures, Information Sheet, 18 September 2014. The AEMC's Final Report was published in September 2014 and provided to COAG Energy Council. The report recommended (inter alia) amending the NER to require the AER to develop, publish and maintain a guideline containing the recommended definitions of reliability measures.
118 See Design, Reliability and Performance Licence Condition, imposed on the three DNSPs by the Minister for Energy and Utilities, dated 1 August 2005 and available on the IPART web site.

conditions also expanded the networks' obligations for reliability reporting to include IPART and the NSW Minister for Energy.[119]

For example, Ausgrid's distribution licence required Ausgrid to design to a "N-2" input standard in the Sydney Central Business District (CBD). An "N-2" design standard means that there are two layers of redundancy throughout the CBD electricity supply system. For instance, three high capacity power lines must be constructed so that if two lines fail, the overall electricity supply can still continue to that area of the network.[120]

In other areas of the network, the design standard specified in the licence is "N-1". These are engineering type requirements that do not take account of the probabilities of particular events or alternative and lower cost ways of managing the risks of one event turning into widespread disruption of the electricity network.

These deterministic design criteria in the licences, therefore, greatly reduced the flexibility of the networks to optimally configure the networks to achieve the output reliability targets that were also set in the licence. In this way, the NSW Government of the time, perhaps unintentionally, added substantially to the level of new investment required.

At the same time, the output measures of reliability suggested that, from a consumer's perspective, the reliability of the service was no better than that achieved by the privatised networks in other jurisdictions. These networks were only subject to regulation of output measures of supply adequacy (e.g number of minutes off supply), and were left to assess the optimal design to achieve this— taking into account the probabilities of different events and the impact on consumers.

As noted above, the cost to consumers of the additional licence requirements in NSW was substantial. IPART, who was at that time responsible for the management of the licences and the NSW network revenue determinations, approved an increase in the total allowed revenue of some $350 million dollars ($2005-06) over the three years from 2006-07 to 2008-09. This increase in the total revenue allowance for the three NSW distribution networks was, in turn, based on increases in the allowed capital expenditure of some $1,342 million ($2005/06) and an increase in allowed operating expenditure of some $192 million. The $1,342 billion of capital expenditure flowed directly through to the value of the networks' RABs and, therefore, to a higher allowance for the cost of capital.[121]

The input design criteria in the NSW licences were finally removed on 1 July 2014. However, in the meantime, consumers continued to pay for the higher investment and for the return on capital costs of the higher RAB.

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119 Minister for Energy, Design, Reliability and Performance Licence Conditions for Distribution Network Service Providers, December 2007.
The new conditions are set out in Schedules 1 – 3 and include design planning criteria, average reliability standards (for SAIDI and SAIFI) and individual feeder standards (SAIDI and SAIFI) http://www.ipart.nsw.gov.au/files/9c9eef97-8a35-4b95-901a-a16900bdef9b/
120 Ibid, 14-15.
121 See IPART, NSW Distribution Network Cost Pass Through Review – Statement of Reasons for Decision, 5 May, 2006. The amounts referred to in this report are summarised from Tables 1, 2, 3 and 4 of IPART's Statement of Reasons.
http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Network_Pricing/NSW_Electricity_Distribution_Network_Service_Providers_-_Applications_for_a_cost_pass_through

6.1.2 A national framework for network reliability regulation

While the section above maps out the important developments in the NSW regulation of reliability, this section considers the parallel developments in the regulation of reliability at the national level.

It is important to note here that there are few specific national requirements around reliability of the network services in the NER. The NER does state that the AER must develop a Service Target Performance Incentive Scheme (STPIS)[122] and the AER must set out how it intends to apply the Scheme in the Framework and Approach report that must be prepared for each determination.[123]

The NER sets out some high level principles rather than the specific contents of the AER's STPIS. For example, it stipulates that the STPIS must consider any past performance of the network and the willingness of customers to pay for improved services.[124] It is also a requirement that the AER must consult with jurisdictional regulators and take into account any jurisdictional scheme or licence requirements in setting the allowed capital and operating expenditures of the networks.[125] In that sense, if there is a jurisdictional scheme, such as the NSW licence arrangements, these take precedence in the determination of the allowed revenue.

Nevertheless, the STPIS can be applied in parallel to a state scheme. It is an incentivebased scheme that provides rewards and penalties for networks that performed better or worse than the targets set at the commencement of the regulatory period. These targets need not be the same (and are generally not) as the state-based targets, although the AER is required to take the state schemes into account.

The overall intention of the STPIS is to provide a balance to the AER's other incentive scheme, the Efficiency Benefit Sharing Scheme (EBSS), and more recently, the Capital Expenditure Sharing Scheme (CESS).[126] The EBSS rewarded networks for spending less than their regulatory allowance for operating expenditure. Therefore, it was important to ensure that they did not make this saving in operating expenditure at the expense of the reliability and quality of the network. A similar logic applies to the relationship between the STPIS and the new CESS.

The NSW networks were not subject to the STPIS in the first regulatory period (2009-2014) under the AER, although the AER and the networks agreed to a "trial" operation of the STPIS that did not include rewards or penalties. However, the AER will apply the national STPIS scheme to the NSW networks for the four years 2015-2019, with a maximum reward and penalty rate ("revenue at risk") of between 2.5 and 5 per cent of network revenue per year.[127]

The targets set by the AER will be based on historical performance of the networks, to encourage gradual improvement in performance. The AER is looking to eventually link these targets more closely

122 NER, Clause 6.2.2 (a).
123 NER, Clause 6.8.1 (b)(2)(iii).
124 NER, Clause 6.2.2 and specifically (b) (3) (iii), (vi).
125 NER, Clause 6.2.2 (b) (1).
126 The CESS will apply for the last four years of the current regulatory period, i.e. 2015- 2019.
127 The National STPIS that includes a maximum revenue at risk of +/- 5%. The NSW networks sought +/- 2.5% in their regulatory proposals. The AER has stated that it will set the revenue at risk during the course of the regulatory determination and reflective of the particular circumstances of each distributor. The AER has also stated that it will not apply the Guaranteed Service Level (GSL) component of the STPIS given that IPART already applies a GSL scheme. See, AER, Stage 2, Framework and approach, Ausgrid, Endeavour Energy and Essential Energy, January 2014,15.

to the findings of studies on the value of reliability to consumers.

In summary, while the AER's STPIS arrangements overlap the NSW licences in some respect, there are some differences between what is measured and how the measures are defined. Importantly, the AER does not set mandatory targets, although the financial penalties and rewards can be quite substantial.

Nevertheless, there is a strong argument that state governments should move wholly to the national scheme, or at least, should do so for key measures such as system average interruption duration index (SAIDI) and the system average interruption frequency index (SAIFI). Having parallel measurement of these schemes, with different targets adds to the complexity of the process without necessarily improving outcomes. In addition, moving to the national STPIS means better integration of investment in reliability with the economic regulation of the networks under the AER.

As will be illustrated below, Victoria has "handed over" much of the measurement of reliability to the AER, yet has not seen any decrease in service standards as a result of this action. However, whatever method is adopted in NSW – be it parallel measurement or transfer to the AER, in both instances, the key issues remain. What are the best measures, and what targets should be set on those measures?

Recommendation 29: The NSW Government should consider the costs and benefits to electricity consumers in NSW and to potential buyers, of the option of transferring responsibility for the control and measurement of reliability to the AER, following the lease of the assets.

6.1.3 Influences on the regulatory determination processes

In a similar vein to the previous discussion of network revenues and pricing, one concern with a national regulatory process for setting reliability standards is that it may become remote from the people affected by its decisions. A similar situation can arise if this is left to the NSW regulator.

However, the particular issue in NSW is that the Minister sets the reliability standards and targets. There is always the potential for standards and targets to reflect shorter-term issues.

Given that all the consumers in a distribution region will pay for this decision, it may not always be to the community's advantage.

However, that same community is the one most immediately affected by any decline in standards. Therefore, it is essential that any regulatory process that sets the standards and targets for reliability does so on the basis of extensive discussions with that community and the careful and objective measurement of the value the community places on reliability.

Recent research by the Australian Energy Market Operator (AEMO) on the value of customer reliability (VCR) has provided considerable insight into this question, identifying the value different customer sectors in different states place on reliability.[128] We recommend that the NSW Government

128 See: See: AEMO, Value of Customer Reliability, Final Report, September, 2014. http://www.aemo.com.au/Electricity/Planning/Valueof-Customer-Reliability-review

carefully consider the results of this study and, to the extent they retain responsibility for reliability, incorporate the findings of the VCR study into the licence conditions. It would also be beneficial for the NSW Government to work closely with the AER and AEMO in doing this.

Recommendation 30: If the NSW Government retains the responsibility for the control and measurement of reliability, it should investigate the findings of the AEMO study into the value of customer reliability, and take these findings into account when setting the NSW distribution licence conditions in the future.

6.2 Will the lease of the NSW network assets affect network reliability?

The discussion above highlights the many issues that are still to be resolved at a state and federal level regarding the most efficient way of regulating reliability, of establishing reliability measures and targets, along with the reporting of these outcomes.

Nevertheless, from the perspective of NSW electricity consumers, the most immediate question is whether privatisation, per se, will increase the risk of decline in the reliability of the NSW networks. Various comparative studies have provide some insight into thisquestion. In general, there is certainly no evidence from the experience of privatisation in other states to suggest that privatisation adversely affects the quality and reliability of network services. Subject to our concerns about governance issues, there is no reason to believe that the partial leasing of the NSW network assets will change this conclusion.

In the following sections, this issue is examined from two perspectives:

- a comparison of the reliability performance of distribution businesses in different states, noting that both Victoria and South Australia privatised their network assets over 15 years ago; and
- an examination of changes in Victorian reliability from the commencement of the privatisation of the network assets. This addresses the question of whether the privatised businesses simply take advantage in the early years of the "gold-plated" condition of the publically owned assets they inherited.

In considering these two perspectives, the report relies principally on two measures of reliability, the system average interruption duration index (SAIDI), and the system average interruption frequency index (SAIFI). These measures tap directly into consumers' experience of the service and are widely used measures of reliability.

The wide-spread use of these measures (albeit not always consistently measured[129]) also facilitates comparisons across networks and over time. Other output measures of reliability have also been adopted in different states, such as momentary interruption of supply, or time to respond to customer

129 See for instance, AER, State of the Energy Market, 2013, 80. The AER states that the accuracy of the business information systems that record SAIDI and SAIFI may "vary considerably".

calls, but they are defined in different ways and are therefore not always comparable across networks. This report therefore focuses on SAIDI and SAIFI as providing the most consistent (but not perfectly so) measure across time and place. It looks first at the reliability of distribution networks, and then at the reliability of transmission networks.

6.2.1 Distribution network reliability

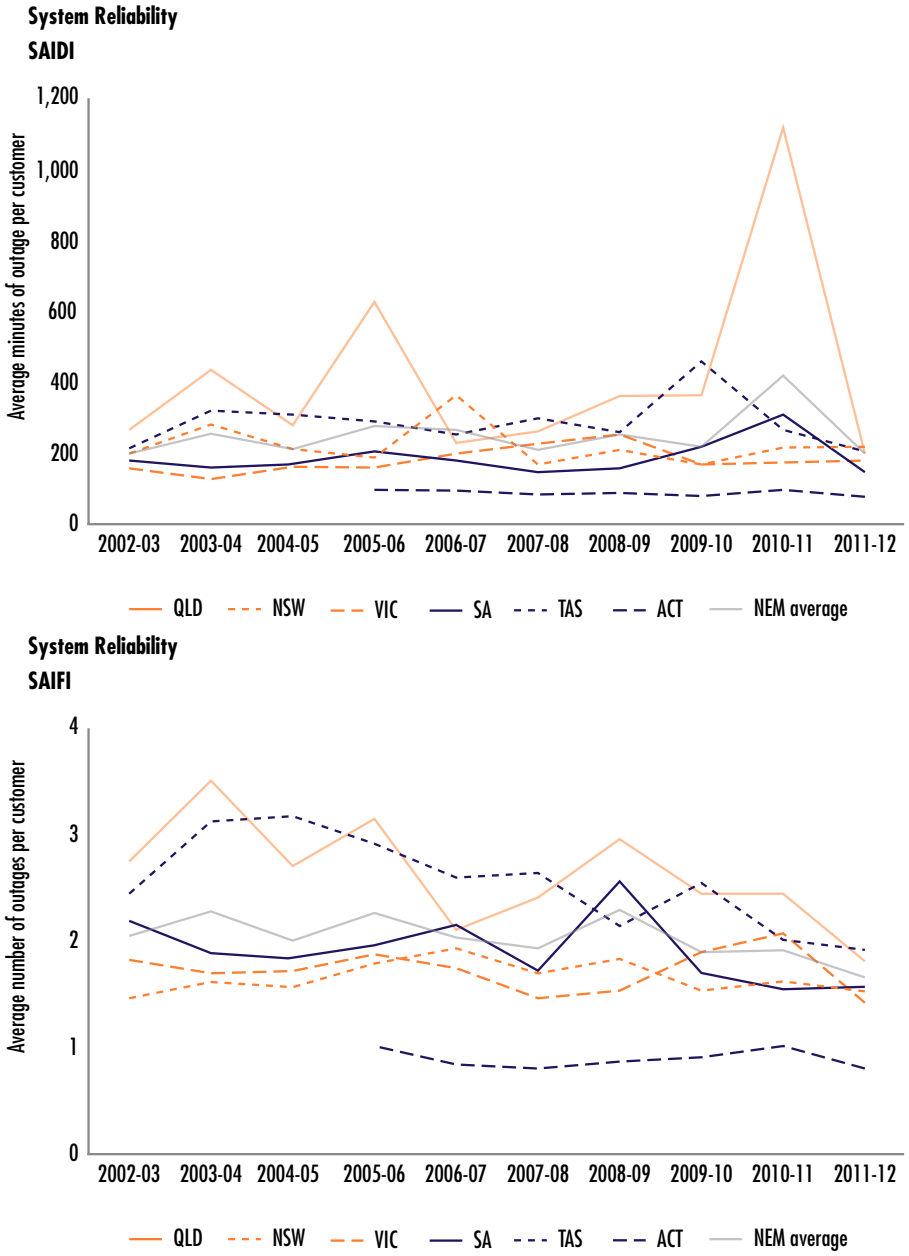
The AER's State of the Energy Market Report, which has been produced each year since 2007, provides the most consistent source of historical data on SAIDI and SAIFI across the distribution networks in the National Energy Market (NEM).

When looking at historical data, it is important to look at the trends rather than the individual annual measures, as some networks, such as those in Queensland, are more affected by significant weather events than other networks.

Looking at the trends over the last 10 years, some key observations include:

- The performance of the Victorian and South Australian networks, the two privatised networks, is generally better than the average of all the NEM jurisdictions;
- SAIDI has remained relatively constant for most networks since 2002-03, despite the very substantial differences in capital expenditure (on a proportionate basis) by the different networks; and
- There has been a slight improvement in SAIFI, but this is largely driven by improvements in the Queensland outcomes. The trend performance of the NSW, Victorian and South Australian networks on the SAIFI measure remains reasonably constant (although clearly there are individual years where performance varies from trend, largely due to extreme weather events).

Figure 10: Average reliability by jurisdiction for 2002-03 to 2011-12



Source: AER, State of the Energy Market Report, 2013, Figure 2.8, 81.

Lower scores represent less interruption to supply, that is, greater reliability.

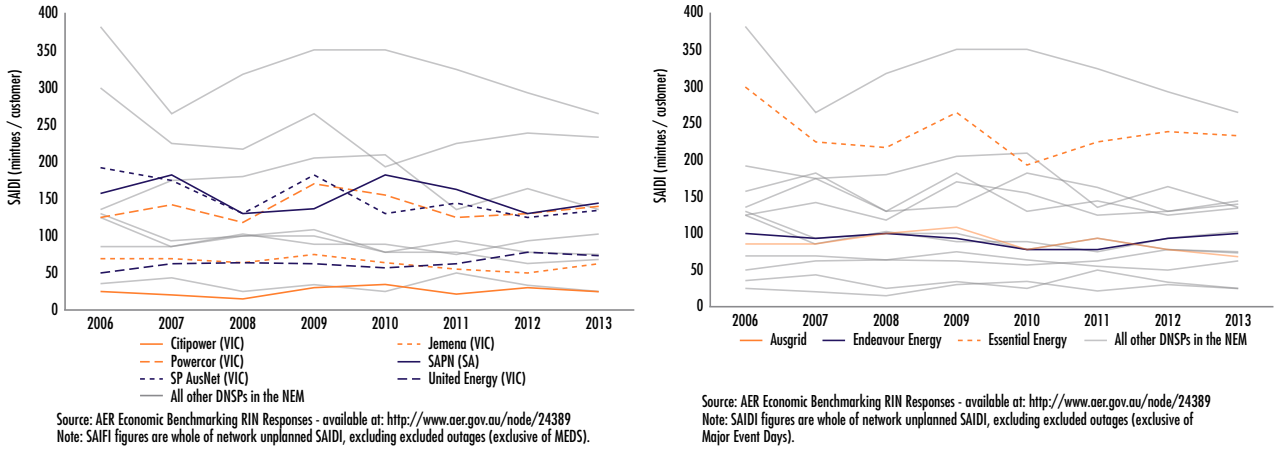
HoustonKemp provided a more recent report to the NSW Government (August, 2014)[130] of the reliability of each of the privately owned distribution networks compared to the other networks in the NEM, using the data provided by the networks to the AER in their regulatory information notices and

130 HoustonKemp, Electricity Networks Service Standards: An Overview, A Report for the NSW Department of Premier and Cabinet, Final Report, 2 September 2014, 26.

covering the period 2006 to 2013.

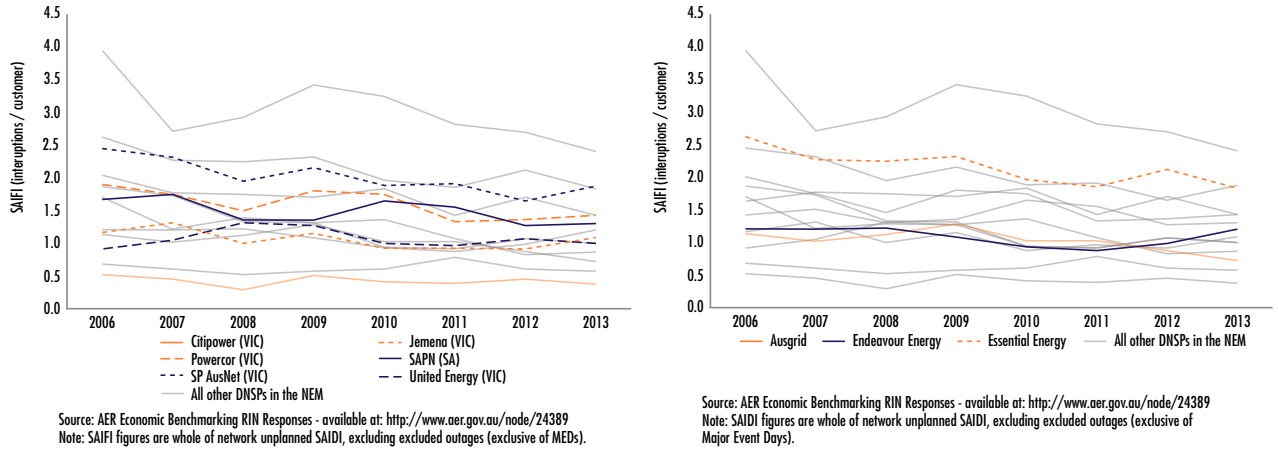
The HoustonKemp (2014) study generally confirmed the observations made in the AER's State of the Energy Market report. There was little change in the SAIDI measures and a slight trend improvement in SAIFI, although there were variations from this trend in individual years. Nevertheless, it would appear from Figure 10 and Figure 11 below that when comparing networks with similar topological characteristics (i.e. CBD with CBD, urban with urban, rural with rural networks), the privately-owned networks compared favourably with government-owned networks.

Figure 11: Reliability of public and private owned distribution networks – SAIDI



Source: HoustonKemp (2014), Figures 7 & 5, 24 & 26.

Figure 12: Reliability of public and private owned distribution networks- SAIFI

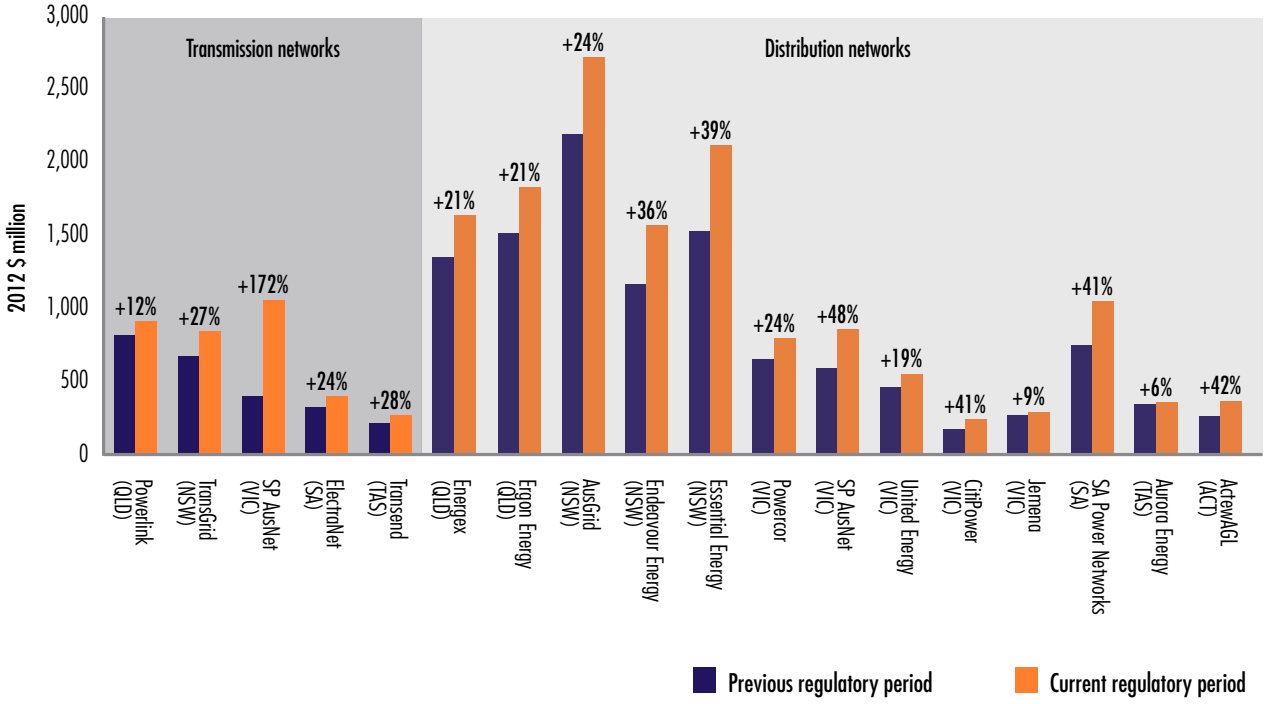


Source: HoustonKemp (2014), Figures 8 & 6, 24 & 26.

Overall, what is most striking about these results is that reliability has remained so constant, despite the many billions of dollars invested in the network system over the two relevant regulatory periods (between 2002-03 and 2011-12, particularly in NSW and Queensland.

The comparable level of capital investment is illustrated in Figure 12. This chart provides a summary of the level of capital investment by each transmission and distribution network over the last two regulatory periods.[131]

Figure 13: Electricity network investment for each network in the NEM ($2012 million)



Notes:
Current regulatory period expenditure reflects forecasts in regulatory determinations, amended for merits review decisions by the Australian Competition Tribunal.
The increase in SP AusNet's transmission operating expenditure in the current period was partly due to the introduction of an easement land tax (around $80 million per year) mid way through the previous regulatory period.
Sources: Regulatory determinations by the AER.

Source: AER, State of the Energy Market Report, 2013, Figure 2.7, 74.

Historical trends in distribution reliability in Victoria: the impact of privatisation

As highlighted previously, it is also relevant to consider what happened in Victoria in the decade immediately following the privatisation of the electricity networks in 1995-96. The subsequent decade featured a number of changes to the ownership of the privatised networks that, in principle, are likely to add to the challenge of maintaining continuity in investment and reliability of the network services.

On the other hand, the Victorian Government moved forward with the establishment of an independent regulator. In 1994, prior to sale of the electricity networks, the Government established

131 Ibid, Figure 2.6, 73.

the Office of the Regulator-General[132] (ORG) with a mandate to make its determinations independently of the Energy Minister including setting network revenues and monitoring reliability outcomes as part of the first regulatory incentive scheme. The ORG succeeded in placing relatively tight parameters on revenue and expenditure allowances, and reliability outcomes.

For instance, the AER's 2007 State of the Energy Market report stated that between 2001-02 and 2005-06 capital expenditure (capex) in the distribution networks increased by a much greater amount in NSW and Queensland than in Victoria and South Australia.

Figure 14 below summarises the percentage increase in capital expenditure over the period 2001-2006— as well as the percentage this new expenditure represents of the RAB.[133] The percentage capex to the RAB indicates the relative intensity of the capital expenditure program and the impact it will have on the growth in the RAB and future price trends.

The pattern of higher capital expenditure in government-owned networks between 2001 and 2006 continued into subsequent regulatory periods as was discussed in the previous section of the report and illustrated in Figure 12. However, in this section we are investigating earlier outcomes, to identify expenditure and reliability patterns in the period more immediately following the sale of the Victorian networks.

Figure 14: Distribution networks: capital expenditure and reliability – 2001-2006

JURISDICTION	Increase in capex (%)	New capex as % of RAB	Reliability trend (SAIDI)
New South Wales	62%	13.6%	stable
Queensland	110%	13.4%	stable
Victoria	13.7%	10.2%	stable
South Australia	28.5%	7.2%	stable

Source: AER, State of the Energy Market, 2007. The change in the SAIDI reliability measure is estimated from Figure 14 that is also taken from the AER's 2007 report.

Various explanations have been given for this greater expenditure, such as the age of the network or the growth in peak demand, although limited evidence has been provided to substantiate these claims.[134] However, in the context of this report, the important issue is whether the additional expenditures incurred by the government-owned electricity networks were correlated with improvements in reliability performance relative to the privately-owned networks with much lower capital investment.

132 The legislation to establish the Victorian Office of the Regulator-General was passed in May, 1994, prior to the privatisation of the electricity networks. The legislation specifically stated that the Office is "not subject to the direction or control of the Minister in respect of any determination, report or inquiry", other than when the Minister has issued a "statement of government policy". See: Office of the Regulator-General Act 1994, Act No. 42.1994 @ s.11. In 2002, the ORG was subsumed into the Essential Service Commission of Victoria. http://www.austlii.edu.au/au/legis/vic/hist_act/ootra1994271.pdf

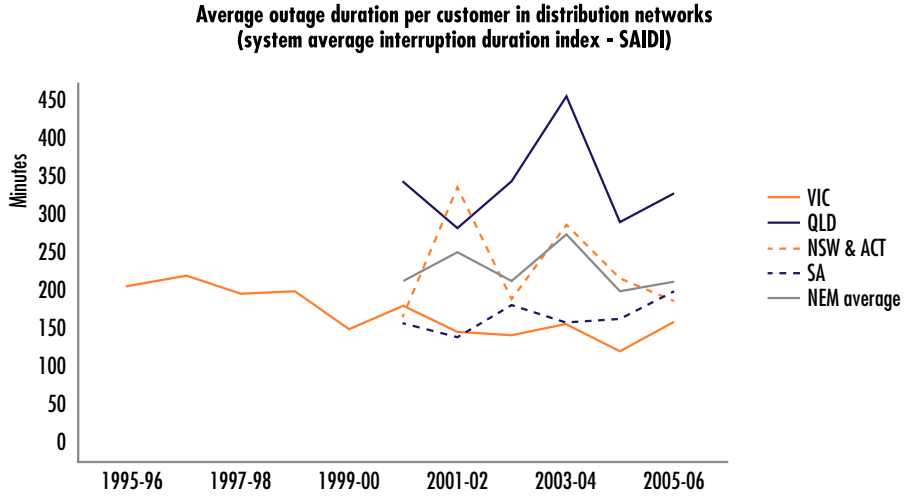
133 AER, State of the Energy Market, 2007, 153.

134 For a detailed review of these claims see Mountain B., Independent regulation of government-owned monopolies: An oxymoron? The case of electricity distribution in Australia, Utilities Policy (2014). Mountain reviewed the available evidence for the claim that (inter alia) aging assets, growing peak demand and customer density explained the observed differences between the costs per connection of government owned networks and privately owned networks. He found that none of these three factors explained the difference in costs per customer.

A second, and related question, is whether there is evidence that the lower capital expenditures by the Victorian networks in the decade after they were sold resulted in a decline in reliability. In other words, in the decades following the sale of the Victorian networks has there been an improvement in the relative reliability of the government-owned networks (commensurate with their greater capital investment) and/or has there been a decline in reliability in the privatised networks.

Figure 15 sets out the changes in one of the reliability measures (SAIDI) for the Victorian networks in the decade following privatisation of the networks. Corresponding SAIDI data is provided for the other networks from 1999-2000. (Figure 10 in the previous section includes the comparative SAIDI measure after 2005-06).

Figure 15: Average SAIDI per customer in distribution networks: Victoria 1995 to 2006



Notes: PB Associates developed the data for the AER from the reports of jurisdictional regulators and from reports prepared by distribution businesses for the regulators. Queensland data for 2005-06 is normalised to exclude the effect of a severe cyclone. Victoria data is for the calendar year ending in that period (for example, Victorian 2005-06 data is for calendar year 2005.) NEM averages exclude New South Wales and Queensland (2000-01)and Tasmania (all years).
Source: PB Associates (unpublished)

Source: AER, State of the Energy Market, 2007, Figure 3. Lower numbers means a better reliability performance. The report did not include any information on the SAIFI measure.

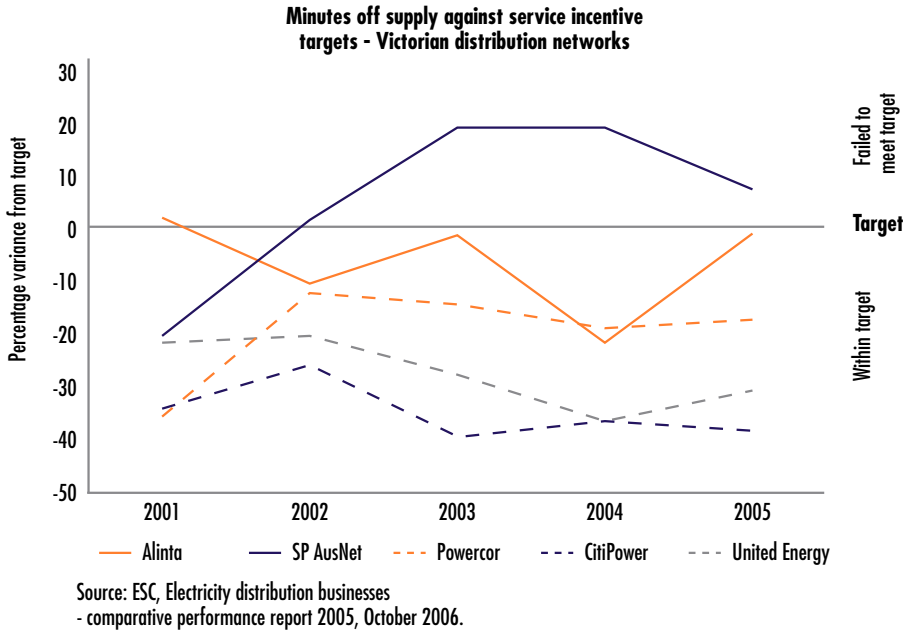
The Victorian Essential Service Commission (ESC; the successor regulator to the ORG) provided a somewhat different perspective; its report broke down the performance of each of the five networks against the reliability service incentive targets that had been set in the 2001-2005 regulatory determination.

The reliability targets were set based on historical performance of the networks, an approach that drives a gradual improvement in reliability over time. Figure 16 below illustrates how each network performed against its target. All but one of the networks performed better than the target set for them, with the exception of SP AusNet. However, SP AusNet had begun to improve its performance by 2005 in the face of potential regulator penalties.

While due care should be taken in comparing year on year results, the chart suggests that the constraint on the capital expenditure allowances for the Victorian distribution networks did not result in loss of

reliability performance for individual networks.

Figure 16: Reliability of service compared to service incentive targets (2001-2005)



Source: AER, State of the Energy Market, 2007, Figure 5.10, 165.

6.2.2 Transmission network reliability

The reliability of transmission networks is particularly important to electricity users. Outages generally have major impacts across a large section of households and businesses.

However, benchmarking across different transmission networks is perhaps more difficult.

The AER for instance, sets individual targets for each transmission system stating as follows:[135]

'Rather than impose a common benchmark target for all transmission networks, the AER sets separate standards that reflect the individual circumstances of each network based on its past performance.'

Transmission networks that exceed their individual reliability targets receive a financial bonus (known as a positive "S factor" adjustment to a network's revenue allowance) —while networks that perform worse than the target are penalised. Based on this approach, the AER reports that over the six years to 2012 "all the [transmission] networks generally received financial bonuses for overall performance".[136]

The AER made a similar observation for the 2003 - 2005 period. The decade-long series of positive S factors also suggests that reliability levels have been maintained across most of the public and privately

135 Ibid, 133.
136 AER, State of the Energy Market, 2013, 78. Table 2.4 includes a detailed breakdown of S factors by each transmission company between 2006 and 2012.

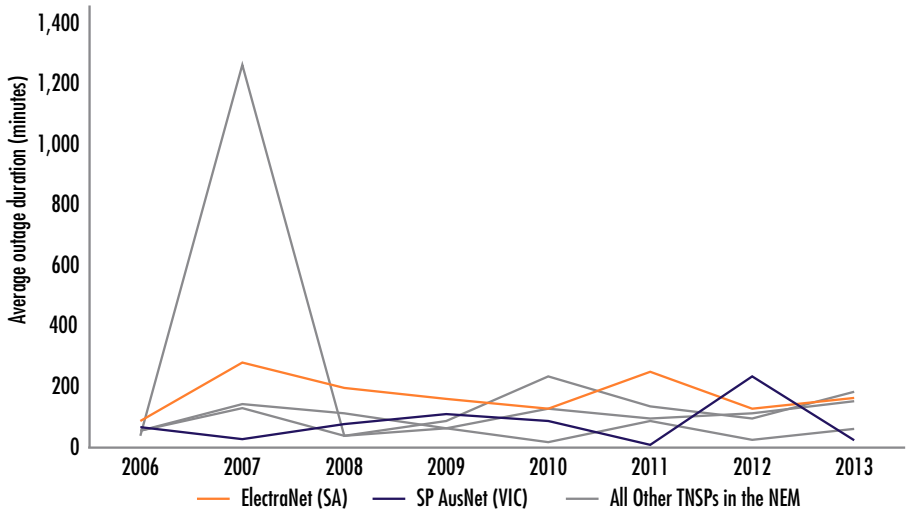
owned networks. For example, the AER noted in 2007 that the NSW, Victorian and South Australian transmission companies each lost fewer than three minutes of supply during 2003-04.[137]

In 2013, the AER reported the same outcome for the 2011-12 period[138], indicating stability across time.

HoustonKemp (2014) analysed transmission reliability for the period 2006 to 2013.[139] They found broadly similar outcomes for private and public transmission networks with both groups performing at a similar standard on the key transmission reliability measure of average outage duration.[140]

Figure 16 compares the reliability performance of Transgrid (the NSW transmission network business) with the performance of other transmission networks, noting that the networks in Victoria and South Australia are privately owned while the Queensland Government owns Powerlink. Other than the major Powerlink incident in 2007, the performance of all transmission companies is very similar and has remained relatively stable between 2006 and 2013.[141]

Figure 16: Outage duration for private and public owned transmission companies (TNSP) (average outage duration in minutes)



Note: The spike in 2007 is for Powerlink and is largely a result of a lightning strike that caused a double transformer failure at Collinsville in early 2007.

Source: AER Economic Benchmarking RIN Responses - available at: http://www.aer.gov.au/node/24389

Source: HoustonKemp, Electricity Networks Service Standards, Final Report, Figure 11, 28.

137AER. State of the Energy Market Report, 2007, Table 4.3, 133.
138 Ibid, 133 and AER, State of the Energy Market Report, 2013, 77.
139 See: HoustonKemp, Electricity Networks Service Standards: An Overview, A Report for the NSW Department of Premier and Cabinet, Final Report, 2 September 2014.
140 HoustonKemp, 2014, 27.
141 Ibid, See Figure 10 & 11, 28.

Historical trends in transmission reliability in Victoria: the impact of privatisation

It is also relevant to consider in more detail the transmission system reliability outcomes in Victoria in the decade following the privatisation of the transmission assets. The findings are similar to the previous analysis of the impact of privatisation on the reliability of the distribution networks.

In particular, the 10 years following the privatisation saw a number of changes in ownership of the transmission system and regulatory restrictions by the ORG and its Victorian successor the ESC on capital investment, particularly when compared to NSW transmission investment. For example, SP Ausnet's investment expenditure was about 36% of Transgrid's between 2002-03 and 2005-06. However, the value of the SP AusNet's RAB was about 60% of Transgrid's,[142] suggesting a lower level of investment by SP AusNet per dollar of RAB value.

Notwithstanding these changes in ownership and lower proportion of capital investment, the Victorian transmission companies exhibited a reasonably constant standard of performance on the reliability targets set for them by the regulator. For example, the ACCC (the then regulator of SP Ausnet) reviewed the reliability of the transmission system and while finding significant year on year volatility, there was no trend towards lower service levels.[143]

6.2.3 Distribution reliability targets: how are they set?

The previous sections have highlighted that the reliability of the privately-owned distribution networks is not inferior to that of the government-owned networks. It also showed that the level of reliability did not decline in the decade or so after privatisation. If anything, the reliability performance of the privatised networks is somewhat better than the publically owned networks and has shown some gradual improvement over time—at least on some measures.

This has come about despite the significant differences over the decade in the proportion of capital investment in the network (relative to the RAB) between the private and governmentowned networks and despite the very different approaches each state has taken to regulating reliability of the networks.

This report previously noted that between 2005 and 2014, the NSW distribution businesses were subject to relatively onerous design criteria requirements that placed inflexible input standards on the network businesses (such as the "N-2" design standard). These replaced the previous arrangements in which the networks were responsible for determining the appropriate level of reliability for their customers.[144] In addition to the input standards, the distribution licences also required the networks to report on more traditional output measures of performance such as SAIDI and SAIFI.

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142 See AER, State of the Energy Market Report, 2007. The percentage figures for capital investment are obtained from Table 4.2 (page 128). The percentage figure for the RAB is estimated from Table 4.1 (page 123). Note there is a 18 month difference in timing of Transgrid RAB (as at July 2004) and SP Ausnet RAB (as at 1 January 2003). Therefore 60% is a conservative estimate of the relative RAB values.

143 ACCC, Transmission Network Service Providers Electricity Regulatory Report for 2002/03, 2004, 39. Note, there are no comparable measures available for the NSW transmission networks in this period.
http://www.aer.gov.au/sites/default/files/Annual%20regulatory%20report%202002-03.pdf

144 See discussion in AEMC, Review of Distribution Reliability Outcomes and Standards, Final Report-NSW workstream, 31 August 2012, Sydney, 1. .
http://www.aemc.gov.au/getattachment/a5bbc0be-e7e3-4fcd-b856-feaf4088d38a/NSW-workstream-final-report.aspx

The amendments to the NSW distribution licences in 2005 and 2007, therefore reflected the Government's decision to set "deterministic" input standards with the intention of ensuring the Sydney CBD and other key urban centres would not suffer major supply interruptions. In contrast, the Victorian Government, faced with much the same concerns because of growing peak demand, continued with the approach of "probabilistic" planning[145], which in turn, provided the networks with the flexibility to determine how best they could achieve the output targets for (inter alia) SAIDI and SAIFI.

The focus of the Victorian Government and the regulator was therefore on setting appropriate targets on the output measures of reliability rather than "engineering" the inputs.

The reliability outcome from an electricity customer's perspective was much the same (as demonstrated above), but the cost impacts of the different approaches were significantly greater for NSW electricity consumers.

In July 2014, the NSW Government amended the distribution licence conditions, removing the deterministic design criteria such as N-2. The focus in future will be on the outputmeasures of reliability (e.g. SAIDI and SAIFI) and the quality of delivery of related services to consumers (e.g. time to connect a customer). The changes have been made to align with the AER's next regulatory determination period (2014-15 to 2018-19).

While it is important that this reform has been put in place prior to the privatisation or leasing of the networks, the NSW Government continues to set reliability targets such as SAIDI and SAIFI in the distribution licences. This creates a second layer of compliance for the networks given the pending implementation of the AER's STPIS. Nor do the targets in the network licences align with the targets set by the AER as part of the STPIS. This is further discussed in the next section.

Reliability targets for the networks : where is the consumer?

Another important aspect of regulating the reliability outcomes is the process adopted by each jurisdiction to set performance levels, or targets, on each of the reliability output measures. That is, having adopted output measures such as SAIDI and SAIFI, the question remains - what level of SAIDI or SAIFI represents the optimal balance between the reliability and cost of supply?

To establish the optimal target requires the regulator to put themselves in the shoes of the consumers. This issue was specifically addressed in Victoria where the reliability targets on measures such as SAIDI and SAIFI were notionally linked to the findings of studies on customers' "willingness to pay" conducted by the Australian Energy Market Operator, AEMO, and its predecessor, the Victorian Energy Networks Corporation.

The South Australian regulator, the Essential Services Commission of South Australia (ESCOSA), sets reliability targets for the South Australian distribution networks based in part on surveys of electricity customers and their views on whether reliability should be improved, decreased or maintained at

145 Probabilistic planning differs from deterministic planning in that it takes into account the probability of different contingencies causing interruption to supply and the value that customers place on reliability. The focus is on defining an optimal level of reliability rather than a set level of redundancy based on multiple equal weighted contingencies (however remote in practice).

current levels. The most recent research by ESCOSA indicated consumers are satisfied with the current level of reliability. As a result, ESCOSA has set the reliability targets for the next regulatory period (2015 – 2020) on the basis of the average reliability of the last five years.[146]

At the request of SCER (now CEC), the Australian Energy Market Operator (AEMO) has recently completed a very extensive research program to update the value of customer reliability (VCR) for each state and customer class within that state, as noted previously.[147]

As part of the study, AEMO sought the views of over 3,000 electricity consumers about their satisfaction with current levels of reliability. AEMO's findings accord with other research such as ESCOSA's (above).

Customers across the various NEM jurisdictions are generally satisfied with the level of reliability of the distribution networks but have very significant concerns with the overall price of electricity and do not want prices to increase even if reliability could be improved by further investment (and higher prices). AEMO also identified that the VCR value was, on average, lower than had been found in previous studies, particularly for business customers

> - a possible reflection of the overriding concern of all electricity market segments with high electricity costs.

However, it is not clear whether the NSW reliability targets set out in the 2014 distribution licenses have been developed with due regard to the views of consumers and their willingness to pay. Nor is it clear the extent to which the NSW Government has been influenced by the AEMC's 2012 Review of NSW distribution reliability outcomes and standards[148] in setting these targets. The AEMC's review suggested there would be a small but positive net benefit to consumers if the reliability targets were lifted somewhat (i.e. made less stringent) in the NSW distribution licences.

The 2014 targets set by the Minister for Energy in the NSW distribution licences for SAIDI and SAIFI are the same as those specified in the updated 2007 distribution licences.

However, while these have not changed in response to consumer research, the rigid input design criteria have been removed. This may provide an opportunity for the NSW networks, whether privatised, leased or retained in government ownership, to adopt more efficient, lower cost methods of meeting the required reliability targets, including expanding their demand management programs.

The AER's STPIS also sets out targets on the SAIDI and SAIFI and, as noted, the STPIS targets will be integrated into the AER's overall revenue decisions for the NSW networks from 2015-16 to 2018-19.[149]

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146 ESCOSA, SA Power Networks Service Standard Framework 2015 to 2020. The targets will be used as input into the AER's review of SA PowerNetwork revenue requirements for 2015-2020, http://www.escosa.sa.gov.au/projects/194/sa-power-networks-service-standardframework-2015-to-2020.aspx

147 See: AEMO, Value of Customer Reliability, Final Report, September 2014, updated 27 November, 2014. SCER requested the study seeking an update of the original Victorian VCR studies and extension of this to all states in the NEM, for use in planning and revenue setting. http://www.aemo.com.au/Electricity/Planning/Value-of-Customer-Reliability-review 148 AEMC 2012, Review of Distribution Reliability Outcomes and Standards, Final Report-NSW workstream, 31 August 2012, Sydney.

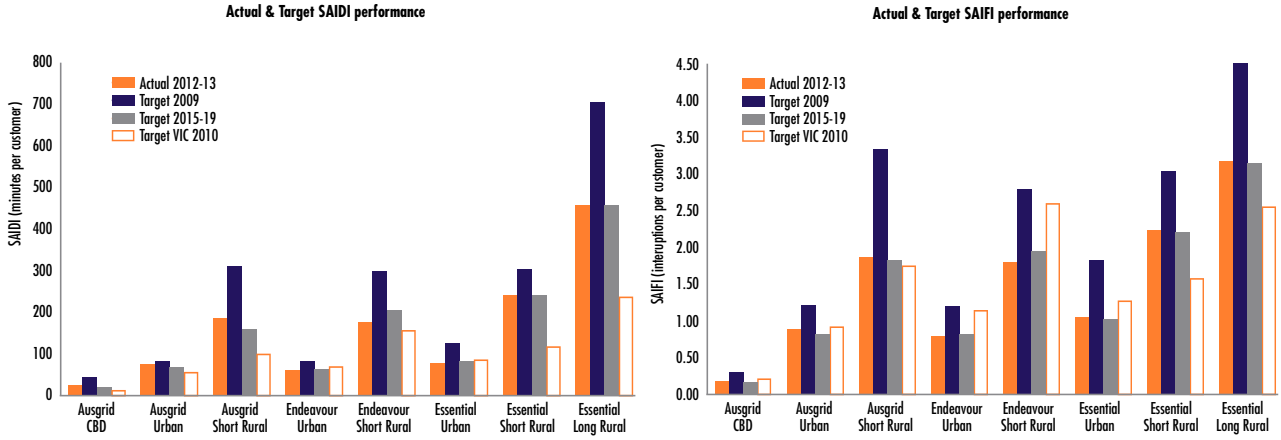
149 The AER set out its approach to the implementation of the STPIS for NSW distribution businesses in AER, Stage 2 Framework and approach Ausgrid, Endeavour Energy and Essential Energy, January 2014. The AER confirmed in this report that it would not apply the national STPIS to the NSW networks in the transitional year (2014-15).

Given the AER is proposing rather large cut backs in capital and operating expenditure, the STPIS will have a very important role in providing incentives to maintain service standards while cutting costs.

The NSW networks have proposed new targets for STPIS measures in their recent regulatory proposals to the AER (May 2014). The proposed targets are based on the last five years of actual reliability outcomes and are significantly more stringent than the targets set in 2009 for the "trial" STPIS. The AER has rejected proposals to spend additional capital expenditure to achieve even higher reliability targets.[150]

Figure 18: Actual SAIDI & SAIFI performance targets & actual performance.

[Note: lower scores mean better reliability outcomes]



Source: Annual Performance Reports for 2012-13 (NSW networks), Regulatory Proposals for NSW Networks for 2014- 2019. The Victorian target figures are based on comparable Victorian businesses (CBD, Urban, Short rural, long rural) with targets as per the respective AER's regulatory 2011-16 determinations for the Victorian distribution businesses.

6.3 Network reliability in NSW: what conclusions can be made?

At the beginning of this Chapter, this Report raised a number of consumer questions about the impact of privatisation on the reliability of the network. The report notes that NSW networks are already performing better than their targets, but so too are the privatised networks. The discussion below highlights a few of the main questions and assesses them on the basis of the information provided above.

- Argument: The overall reliability of privatised network businesses will be inferior to the government-owned businesses because the private owners are concerned with profits not consumers.

Response: The report has examined this issue from a number of perspectives and over an extended

150 The AER's Draft Decision, Attachment 11, November 2014 has confirmed the approach, and has adopted STPIS targets based on historical performance trend with additional adjustment for previous capital expenditure; the AER has rejected the networks proposals for additional capex related to further improving reliability. See for instance AER's review of Ausgrid's STPIS proposal, (at 11 -8). http://www.aer.gov.au/sites/default/files/AER%20–%20Draft%20decision%20Ausgrid%20distribution%20determination%20–%20Attachment%2011%20–%20%20Service%20target%20performance%20incentive%20Scheme%20–%20November%202014.pdf

time frame. There is no evidence to suggest that the privately owned network delivers a lower reliability. On most measures, their performance is as good or better than the publically-owned networks, despite the lower levels of investment.

- Argument: Privatisation of an electricity network will lead to a decline in reliability over time because private owners seek to reduce capital investment and maintenance expenditure.

Response: Figure 14 illustrates that in the decade following the privatisation of the Victorian networks, there is no evidence that reliability declined. If anything, Figure 14 demonstrates progressive improvement in the SAIDI measure over the decade.

Figure 10, covering the period from 2006 – 2013, similarly showed no evidence of a decline in SAIDI.

- Argument: Without government ownership, there will be no party able to impose reliability standards or drive improvements in the networks.

Response: Again, it is not evident that this is the case. The regulatory framework was the main driver of the higher reliability performance of the Victorian networks. This regulatory framework sustained good performance levels, despite the organisational disruption caused by several changes in ownership that occurred in the first decade after privatisation.

This outcome suggests that an effective regulatory framework and strong independent regulator can assist not only in driving improved performance, but in adding resilience to the network operations.

However, we remain concerned about a number of issues and urge the NSW Government to give further consideration to these.

The partial leasing model would appear to create a more complex set of governance arrangements along with potentially competing cultures, skills and systems. It is even more important therefore that there be consistency and transparency in the processes by which reliability is managed and targets set.

The reforms by the NSW Government to date, such as removing rigid input design criteria, are most welcome, but do not go far enough. There is an urgent need for further rationalisation of the regulation of reliability standards and targets, and the process by which these targets are set.

Overlapping requirements such as between the licences and the AER's STPIS simply add to cost. The experience from Victoria is that removing one layer of regulation (in this case, the licence requirements), does not lead to a loss in reliability performance and it would be well worthwhile for the NSW Government to investigate this option further—particularly as there will be a clear benefit to any new buyer to have a single reliability framework in operation.

In making this assessment, the NSW Government should take into account the strong recommendations from the Productivity Commission in their 2012-13 review of electricity network regulation. For instance, the Productivity Commission stated in Recommendation 15.1:[151]

'All jurisdictions should adopt the Australian Energy Regulator's Service Target Performance Incentive

151 Productivity Commission 2013, Electricity Network Regulatory Frameworks, Report No 62, Canberra, 58. http://www.pc.gov.au/__data/assets/pdf_file/0016/123037/electricity-volume1.pdf

Scheme as the basis for setting efficient reliability requirement's for distribution businesses. The Scheme should replace all existing jurisdiction-specific distribution reliability requirements.'

If however the NSW Government wishes to retain some direct control over the process then the following enhancements to existing arrangements would reduce costs and achieve more consistency and transparency for the benefit of both consumers and the buyers of the leases. This benefit will be maximised if the work is progressed before the lease.

- the roles of the state government, the state regulator (IPART) and the AER should be in clarified, along with a streamlining of the regulatory instruments and reporting requirements.
- the targets set out in the licences should be consistent with the AER's targets in the STPIS;
- the targets should be based on empirical research (such as the AEMO study) on the value that customers place on the different components of reliability;
- the NSW Government should consider ways in which it can progress the recommendations in the AEMC's 2014 review of distribution reliability standards;[152] both in NSW and at the national level through its influence in COAG and CEC

The AEMC's 2014 review of distribution reliability standards was conducted at the instigation of SCER and was part of a series of studies on reliability standards conducted over a 2-year period. The AEMC's recommendations are sensible, covering such basic matters as establishing common definitions of the reliability standards and the development of a guideline by the AER that includes these consistent definitions. The AEMC believes these recommendations have the potential to "improve the consistency and transparency of the various distribution reliability incentive, reporting and benchmarking schemes used in the NEM".[153]

In the AEMC's broader recommendations, the setting of targets could remain with the state governments or regulators, but should be set on the basis of the value customers place on reliability. The option was open for the state governments to transfer responsibility for this to the AER.[154]

The NSW Government is well positioned to take a leadership role in ensuring the recommendations from the AEMC's studies are progressed in NSW and across the NEM.

Standardising and simplifying these processes reduces risk and adds value. As the AEMC highlighted, adding certainty and consistency in the regulatory approach reduces risks to the purchaser and is likely, therefore, to increase the perceived value of the assets or the lease.[155] There are also benefits for the network retained in Government hands, and around the transparency of the activities of the leased networks in the future.

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152 AEMC 2014, Review of Distribution Reliability Measures, Final Report, 5 September 2014, Sydney. http://www.aemc.gov.au/getattachment/792bdac4-bfec-45a4-9a95-d4cc8f710db7/Final-Report.aspx
153 Ibid, ii.
154 These recommendations are set out in the AEMC's other reports. For instance, see AEMC 2013, Review of the national framework for distribution reliability, Final Report, 27 September 2013, Sydney. i – ii. http://www.aemc.gov.au/getattachment/a6e9ec7b-e2e1-4908-b357-68a518ae61b2/Final-report.aspx
155 AEMC 2014, Review of Distribution Reliability Measures, Final Report, 5 September 2014m Sydney, iv.

In summary, there are a number of regulatory mechanisms that will secure the ongoing reliability of the NSW networks, whether privatised or not. These regulatory mechanisms currently exist at a jurisdictional level (under the licences et al) and at a national level (under the AER's STPIS arrangements) and will apply to all three NSW distribution businesses in the 2015 – 2019 regulatory period.

The STPIS is likely to set reliability targets that are tighter (better) than the 2014 targets set by the Minister for Energy in the distribution licences. Importantly, the STPIS targets will be set on the basis of the networks' current reliability performance. Therefore they should not lead to additional claims for cost allowances. Aligning the STPIS with current reliability performance also accords with consumers' expressed preferences to maintain current levels rather than spend more resources on reliability as identified by AEMO et al.

It can be concluded, therefore, that the privatisation or partial lease of the distribution businesses is not, per se, a risk to the continuation of the current levels of reliability. It is the strength and independence of the regulatory framework and the regulator that is the key—whether state-based or national.

The jurisdictional and/or national regulatory framework will apply irrespective of ownership, with the same penalties and rewards for service performance. In addition, consumers in NSW should have confidence that the AER's STPIS scheme is now well established, and has proved to effectively and efficiently manage reliability in other jurisdictions through independent national regulatory processes linked directly to the economic regulation of the networks and the value that customers place on reliability.

We conclude with only one caveat. We remain concerned that, if not very well designed, the governance structure of the partial lease may dilute accountability for non-compliance with the licence conditions and/or failure to achieve the STPIS targets. Prior to the lease, the NSW Government needs to ensure appropriate accountability for the Board and senior executives. Breaches of safety requirements should be reported publically at least once a year.

Recommendation 31: Prior to the lease, the NSW Government should set out its commitment to the independent regulation of network reliability standards after the lease, including the development of short-term "early warning" performance measures as well as the standard reliability measures.

Recommendation 32: Prior to the lease, the NSW Government should transfer to the AER the ongoing responsibility for setting efficient reliability targets and the penalties and rewards under the AER's STPIS arrangements, to ensure better alignment of investment and community willingness to pay.

Recommendation 33: Prior to the lease, the NSW Government should review and rationalise the many existing jurisdictional requirements including licence requirements and multiple reporting requirements regarding reliability. The review should aim to minimise future costs for governments, consumers and the businesses.

Recommendation 34: Before the networks are leased, the NSW Government should ensure that the Board and senior executive team has clear lines of accountability and reporting for reliability performance.

6.4 Safety

The electricity distribution and transmission networks are subject to general occupational health and safety legislation, such as the NSW Work Health and Safety Act 2011 No 10, which places a primary duty of care on a business for its employees and third parties. NSW also includes various obligations relating to the safety of employees or the public in industry specific legislation such as:

- Electricity Supply Act, 1995, and associated regulations; and
- Electricity (Consumer Safety) Act, 2006, and associated regulations.

In September 2014, the NSW Government renewed and updated the Electricity Supply (Safety and Network Management) Regulation under the Electricity Supply Act 1995. The objective of the new regulation was set out as follows: [156] 'A network operator must take all reasonable steps to ensure that the design, construction, commission, operation and decommissioning of its network (or any part of its network) is safe.'

The Regulatory Impact Statement (RIS) to the Regulation states: 'the safety of the public and property is the highest priority of the Regulation.'[157] However, the Regulation also covers the safety of persons working on the network, the adequacy and reliability of the network, bushfire risk and customer electrical installations.

To assist in achieving this objective, network operators will be required to develop and implement a safety management system consistent with Australian Standards (AS 5577-2013). The networks will be required to measure and report on their performance, and the reports will be publically available. An independent auditor will be required to audit the safety management plans.

In addition to the legislation described above, there are a variety of industry specific standards, codes and guidelines, including training guides that are designed to protect both the workers in the industry and the general public from danger.

A number of industry-specific committees also oversee the safety and performance of the networks. For example, the NSW Electricity Industry Safety Steering Committee (ISSC) consists of a broad range of industry and government representatives and is chaired by the Energy Branch of Trade & Investment NSW. The ISSC monitors industry compliance with various Codes and has also developed a series of more specific best practice Guidelines for the electricity network industry designed to "'improve electricity network safety in order to eliminate or minimise exposure of people and property to the risk of injury or damage from electricity network hazards".[158]

The NSW Government has introduced a number of regular reporting requirements, such as the annual Electricity Network Performance Report, that includes (inter alia) notification of any safety incidences

156 Electricity Supply (Safety and Network Management) Regulation 2014 – Reg 5.
http://www5.austlii.edu.au/au/legis/nsw/consol_reg/esanmr2014601/s6.html
157 NSW Trade & Investment, Resources & Energy, Electricity Supply (Safety and Network Management Regulation 2014 Renewal, Regulatory Impact Statement, 6.
158 See http://www.resourcesandenergy.nsw.gov.au/energy-supply-industry/pipelines-electricity- gas-networks/electricitynetworks/safety

in some detail.[159] Similarly, networks are obliged to submit various compliance reports to IPART, and conduct periodic audits of their compliance with their licence conditions.[160]

Therefore, whether the distribution and transmission networks are retained by the Government, or leased in full or part, they will continue to be subject to a range of national and NSW regulatory compliance and reporting requirements concerning the safety of their employees, contractors and the general public. Providing the regulatory mechanisms are effectively enforced by the relevant regulatory bodies and independent third parties, the lease of the assets should not, in itself, increase the safety risks to employees, contractors or the public. The renewal and extension of the Electricity Supply (Safety and Network Management) Regulation 2014, cited above, is an important additional protection for employees, the public and the network irrespective of ownership arrangements.

However, in the event of a partial lease with shared ownership, the respective responsibilities and accountabilities of the two parties for ensuring compliance with these requirements, insurance and legal liabilities must be made very transparent to all parties prior to the lease. Breaches of safety requirements should be reported publically at least once a year.

Recommendation 35: Before privatisation (including leasing) occurs, the plethora of regulatory instruments directing, monitoring and reporting safety issues should be reviewed.

Safety, post lease is most efficiently and effectively assured if regulatory gaps are identified and safety related requirements are streamlined, preferably before the leases are granted.

Recommendation 36: The NSW Government should task the ISSC, or similar crossindustry body, with undertaking the consolidation of the various regulatory instruments, and strengthened in terms of its future in monitoring the effectiveness of industry safety codes and guidelines. A clear path, or, "one-stop shop" for the regular public reporting of safety breaches should be put in place prior to leasing the assets.

Recommendation 37: IPART should be made responsible for the management of the Annual Network Performance Reports, rather than the Minister for Resources & Energy, consistent with IPART's role in monitoring licence compliance. IPART should be empowered to take action for breaches of these safety requirements by the networks.

Recommendation 38: Before the networks are leased, the NSW Government should ensure that the Board and senior executive team have clear lines of accountability and reporting for safety performance.

159An outline of the required content of each network's annual performance report is provided at http://www.resourcesandenergy.nsw.gov.au/energy-supply-industry/pipelines-electricity-gas-networks/electricitynetworks/reporting/2013-Report-Outline-Distribution-Final-SENI-amendment.pdf

160 See http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Licensing/Licence_Compliance

CONCLUSION

The lease process is still being developed and a more thorough analysis of how electricity consumers may be affected is difficult without further details. However, it is important to carefully consider the impact any proposal may have on electricity consumers now, because now is the time where options to maximise benefits and manage risks are still available.

This report does not argue against privatisation and its authors remain agnostic about whether the networks should be held in public or private ownership. Whatever the future holds, we strongly believe that the lease process should occur in a considered, transparent manner that provides consumers with all of the facts about how it will work for them and enables them to make informed decisions about whether or not to support it.

Much of the information discussing privatisation infers that over time, privately run businesses deliver savings. These comments have been made by the NSW Government in regard to its expectations that 'networks will become more efficient over time as a result of partial leasing'[161].

Still, it is difficult to understand how the partial lease of the networks, which is effectively a hybrid of public ownership and privatisation, will be positioned to deliver the best of both worlds. We look forward to hearing more from the Government about how this arrangement will deliver savings to electricity consumers in the Essential, Endeavour and Ausgrid supply areas.

We also urge the Government to remain mindful about the importance of a strong, independent regulatory framework, with well-resourced regulators, in the post-lease environment.

Regardless of ownership, electricity consumers deserve networks that are proactively managed to ensure people do not pay any more than necessary for the reliable and safe supply of electricity. These networks need to be agile and responsive to changing demand; and accountable to the public for their business decisions.

Potential changes to essential services can create concern among consumers and the community broadly. We urge all those involved in the process to remember that electricity is an essential service and aim for lease proposals that consider the potential impacts on electricity consumers specifically. An ongoing public consultation process, through which the NSW Government can demonstrate how it has taken consumer impacts into consideration, would be warmly welcomed by NCOSS and electricity consumers alike.

We look forward to continuing the discussion with the NSW Government as proposals to change the ownership arrangements for the NSW electricity networks are further developed.

161 NSW Government, Rebuilding NSW: Discussion Paper, 2014, 12.