14 February 2019

John Mackay
Project Leader
Australian Energy Market Commission (AEMC)

Submission via AEMC website

Dear Mr. Mackay,

Re: 2019 Economic Regulatory Framework Review Approach Paper

The Network Shareholder Group (**NSG**) have invested over $12 billion in Australian electricity transmission and distribution network service providers (**NSPs**) serving more than nine million people across multiple states.

As providers of long-term capital to support reliable and affordable energy network services to customers, we are committed to system stability, reliability and minimising costs to consumers. Investment in networks is required to eliminate pricing disparities within the energy market and facilitate entry of new low-cost generation and storage, which reduce costs to consumers. Investment is critical in an energy system that is being disrupted by new technologies and that is transitioning to increasing levels of intermittent generation.

The capital needed to ensure affordable and reliable energy system for consumers will likely be funded by investors like ourselves. And to ensure that such capital is provided at the lowest cost, investors require a regulatory regime that provides confidence to invest efficiently through stability, predictability and transparency of process and outcomes across multiple regulatory periods.

We consequently welcome the AEMC's continued support for incentive-based regulation. Ensuring that NSPs have an opportunity to recover at least the efficient costs and a reasonable return on investment is critical to ensuring obligations are met and services desired by customers are provided at the right time, in the right place and at least cost.

Investors are interested in the outcomes of the AEMC's Economic Regulatory Framework Review because it has the potential to impact the regulatory construct, the cost of capital and opportunities to earn a reasonable return on investment. Any increase in risk that increases the cost of capital, or reduction in financial rewards for seeking out lower cost solutions or investing efficiently, will discourage investment in innovative new solutions and productivity measures which could reduce the cost to customers over time. This will ultimately result in customers paying higher prices for services, bearing higher risk of interruption, and experiencing longer waits for connection than necessary.

To facilitate efficient investment and innovation, we recommend that any changes to the regulatory framework:

1. Remove prohibitions and constraints on NSPs to adopt new and innovative approaches to providing regulated services where they are lower cost;
2. Increase the scope and strength of incentive mechanisms to deliver efficient outcomes based on a robust assessment of the expected behaviour and impact on investment and innovation;
3. Embed strong governance on changes to the regulatory framework to facilitate a stable, transparent and predictable regulatory environment, free from bias and political influence; and
4. Enable efficient price signals to be passed through to retailers and customers to support informed choices about efficient network utilisation, where and when to connect, and efficient energy supply solutions.

The incentive-based framework is delivering benefits to customers

The opportunities for NSPs to outperform regulated returns through efficiency improvements ensures that customers pay no more than the efficient cost of services and are more likely to pay less for those same services over time.

The financial incentive mechanisms available under the current regulatory framework work well and provide strong drive for NSPs to continuously improve efficiency. These financial incentives are taken in to account in corporate investment decisions and planning processes. This regime has delivered benefits to customers as intended; services have been maintained and improved whilst costs are declining. These financial rewards are only realised when intended outcomes are delivered, and well-designed incentive mechanisms ensure these outcomes reflect those desired by customers and the community.

We support ongoing improvements to incentivise efficient investment and innovation

It is important to ensure the regulatory framework is sufficiently flexible to support the continual evolution of the grid and more decentralised energy resources like wind, solar PV, battery storage and increased penetration of electric vehicles. This includes looking at better ways for network businesses to integrate and coordinate distributed energy resources where these are a lower cost alternative to investing in poles and wires. The current regulatory framework prevents this. Therefore, we support expanding the definition of regulated services to enable alternative and innovative approaches to be adopted where they are the least cost option so that costs to all customers are lower over the medium and long term.

The Approach Paper outlines options to improve the incentives for efficient investment and innovation. Providing an explicit financial mechanism or revenue allowance for demand management, or a 'totex' or performance-based regime should increase the incentives for efficient investment and innovation, and we support further investigation of these options. However, mechanisms that have the effect of increasing ex-post review powers, stranding assets and increasing the regulator's discretion, particularly in the absence of appropriate review processes, will increase cost of capital and dampen innovation.

The impact on incentives of these, or alternative models, may not be well understood. Therefore, there is merit in clarifying the role, outlining the benefits and identifying the potential impact of changes on future behaviour and outcomes of the incentives under the regulatory framework. This will reduce the likelihood that a misunderstanding inadvertently leads to a call for changes that result in poor outcomes for customers.

The pursuit of financial reward is a critical element of an incentive-based regime

If NSPs can deliver outcomes that are better than forecast, NSPs and investors should be able to benefit through increased financial reward. This increases the incentive to make greater improvements so that the benefits that are shared with customers are greater.

Realised returns greater than the regulated return is an indication that the incentive-based framework is working and should not trigger reductions in regulated returns or financial incentives for outperformance, in addition to raising performance goalposts at each revenue reset. This would reduce incentives to invest and pursue efficiencies with a detrimental effect on prices and services. This is heightened where there is a risk that past or future efficient investment will no longer earn a regulated return as a result of technological developments. This risk must be removed to maintain low cost of capital and incentives to invest at the right time and in the right things. The ability of NSPs to earn returns on investment commensurate with overall risks (particularly on new or risky investments), and over the life of the investment, is critical and should be a principle explicitly supported by all stakeholders, including regulators, consumer groups and Government.

Strong governance and robust processes should support any changes to the regulatory framework

We agree with the AEMC that any changes to the current arrangements should include extensive and balanced consultation and collaboration between the industry, market bodies, consumers and other stakeholders. In addition, there is likely to be valuable insight and experience available from Ofgem's review of the RIIO2 framework and the AEMC's reviews of stand-alone power systems and embedded networks that should be considered in shaping the future regulatory framework and market design. Therefore, it is appropriate that investigation of higher-powered incentive regimes such as 'totex' and output-based regulation be progressed outside of the AEMC's annual review.

We also encourage the AEMC to take into account the impact of many ongoing reviews and recent decisions on incentives for investment to ensure further actions do not prompt additional reviews to remediate prior decisions. The following table presents the reviews that have occurred since the AER's Ring Fencing Guideline was amended in October 2017 to prohibit NSPs from providing alternative and innovative approaches to providing regulated services and the subsequent reviews that have, on the one hand reduced incentives for efficient investment and innovation and on the other hand called for changes to stimulate efficient investment and innovation.

Timeframe	Reviews and decisions that reduce incentives for investment and innovation	Reviews and decisions that identify a need for further efficient investment and innovation
October 2017	AER Ring-fencing guideline reduces the scope and financial reward for NSPs to provide alternative and innovative lower cost services.	
January 2018		COAG Energy Council report (from KPMG) finds that the current regulatory framework provides poor incentives for innovation investment and that this is exacerbated by the risk of stranding asset bases leading to the need for a higher hurdle rate to make new capital investments.
June 2018	ACCC Retail electricity pricing inquiry recommends consideration of sharing the risk of assets that become stranded by new technology effectively reducing returns and increasing risk on existing and new investment by NSPs.	
July 2018		AEMC Annual review of economic regulatory framework identified a sharp decline in capital investment since 2013 and found that improvements to incentive regime were required to remove bias toward capital investment and support innovation.
		AEMO Integrated System Plan identifies significant additional investment in interconnectors and to support distributed energy resources and renewable energy zones is required to deliver nearly $4 billion in savings to electricity customers.
September 2018		COAG Energy Council seeks advice from the Energy Security Board (**ESB**) to develop an actionable strategic plan to bring forward investment in priority projects and ensure progress on remaining projects in the ISP.
November 2018	National Electricity and Gas laws changed to reduce the powers of the AEMC and increase the powers and discretion of the AER in relation to the rate of return (inconsistent with the Australian Energy Market Agreement) which effectively removed access to judicial review on rate of return matters, increasing regulatory and sovereign risk of investment.	
December 2018	AER RORG significantly reduces regulated returns on investment by NSPs below international and industry comparators.	AEMC recommends a comprehensive reform package to better co-ordinate investment in renewable generation and transmission infrastructure to facilitate transmission and generation investment in the right place at the right time.
	The AER revises its approach to regulatory tax which results in significantly reduced returns to NSPs after being directed to undertake the review by the Commonwealth Minister for Energy.	ESB recommends streamlined regulatory processes, consistency in assumptions and analysis across agencies and to reduce cost and revenue recovery risk so that investment in ISP priority projects occurs within the required timeframe.
		AEMC consults on relaxing regulation to facilitate trials of new technologies and business models.
		AEMC consults on removing the prohibition on NSPs to utilise stand-alone power systems (and potentially other new and innovative approaches) to provide regulated services where more efficient.

We encourage the AEMC to facilitate improved understanding of the role and benefits of the incentive framework by establishing clear direction, a transparent framework for assessment and to guide changes, and appropriate governance processes to make changes. This is critical to facilitate efficient investment and innovation at the lowest cost and a timely response to constraints in the system, rapidly emerging market changes and changing customer needs. Importantly, it will also ensure the cost of capital for all new investments in the energy system, not just energy networks, do not rise to reflect unnecessary additional risk.

We would be happy to meet with the AEMC to discuss this letter and opportunities to further contribute to the review. Please contact us through Sally McMahon via email to sally.mcmahon@sparkinfrastructure.com or by phone on 0421 057 821.

Yours sincerely,

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