



10 August 2012

Mr John Pierce
Chairman,
Australian Energy Market Commission
PO Box A2449,
Sydney South NSW 1235

Dear Mr Pierce,

Proposed Rule Change – Clause 6A.6.4 of the National Electricity Rules: Value of Gamma

In November 2011, SP AusNet proposed a rule change under section 91 of the National Electricity Law (NEL), to correct known errors in the value of γ (“gamma”) that would otherwise apply to forthcoming transmission revenue determinations.

The Proposed Rule provides for a simple once-off correction to the current prescribed value for gamma, to correct for errors identified by the Australian Competition Tribunal (Tribunal) in its recent decision in relation to gamma.

In its Draft Rule Determination dated 28 June 2012, the AEMC determined not to make a draft rule in response to the consolidated rule change request. The AEMC was not satisfied the proposed rules will, or are likely to, contribute to the achievement of the National Electricity Objective (NEO).

This submission responds to the AEMC’s Draft Rule Determination, addressing each of the issues raised by the AEMC in reaching that conclusion.

This submission is made on the assumption that the current version of the relevant Chapter 6A Rules (particularly the clauses addressing the WACC) is applied to SP AusNet’s forthcoming Determination. If developments in the current ‘Economic Regulation of Network Service Providers’ Rule change process renders that assumption moot, this submission should be considered to be withdrawn.

Should any further details be required, please do not hesitate to contact Tom Hallam,
Manager Economic Regulation on (03) 9695 6617.

Yours sincerely,

A handwritten signature in blue ink, consisting of stylized initials 'AP' followed by a long horizontal stroke.

Alistair Parker
Director Regulation and Network Strategy

National Electricity Amendment (Assumed utilisation of imputation credits) Rule 2012

SP AusNet response to the Draft Rule Determination

1 Introduction

In November 2011, SP AusNet proposed a rule change under section 91 of the National Electricity Law (**NEL**), to correct known errors in the value of γ ("gamma") that would otherwise apply to forthcoming transmission revenue determinations, including the determination to apply to SP AusNet (**Proposed Rule**).¹ The Proposed Rule provides for a simple once-off correction to the current prescribed value for gamma, to correct for errors identified by the Australian Competition Tribunal (**Tribunal**) in its recent decision in relation to gamma.

ElectraNet has also proposed a rule change directed at the same issue, but proposing a slightly different solution.

The Australian Energy Market Commission (**AEMC**) has decided to bring together the SP AusNet and ElectraNet rule change proposals into a single consolidated rule change request.

In its Draft Rule Determination dated 28 June 2012, the AEMC determined not to make a draft rule in response to the consolidated rule change request. The AEMC was not satisfied the proposed rules will, or are likely to, contribute to the achievement of the National Electricity Objective (**NEO**) because:²

- permitting gamma or other individual rate of return parameters to be amended on an ad hoc basis outside of the existing framework in Chapter 6A of the NER would undermine the integrity of that framework and create regulatory uncertainty, thereby resulting in an increase in the regulatory risks faced by transmission network service providers (**TNSPs**);
- varying the value of gamma as proposed by SP AusNet and ElectraNet in the absence of analysing the cross-linkages between gamma and the other parameters could result in an underlying change in the incentive arrangements for the TNSPs that would not be in the long-term interests of consumers; and
- it is neither appropriate nor efficient for the AEMC to conduct a review of the appropriate value for gamma or any other parameter, as this review is more appropriately carried out by the AER.

This submission responds to the AEMC's Draft Rule Determination, addressing each of the above issues in turn.

2 Regulatory certainty and transparency

The AEMC states in the Draft Rule Determination that changing one component of the rate of return framework in Chapter 6A of the NER through a rule change could undermine the certainty and transparency provided by that framework.

The AEMC expresses reservations about the rate of return framework in Chapter 6A of the NER, noting that it "does not provide sufficient flexibility to adapt to changing circumstances".³ Notwithstanding these reservations, the AEMC considers that altering a component of this framework

¹ SP AusNet, *Proposed Rule Change – Clause 6A.6.4 of the National Electricity Rules: Value of Gamma*, 18 November 2011.

² AEMC, *Draft Rule Determination: National Electricity Amendment (Assumed utilisation of imputation credits) Rule 2012*, 28 June 2012, pp i-ii.

³ AEMC, *Draft Rule Determination: National Electricity Amendment (Assumed utilisation of imputation credits) Rule 2012*, 28 June 2012, p 12.

would not be appropriate since “having a rate of return framework, regardless of its form, provides a level of regulatory certainty and transparency”. The AEMC concludes that:⁴

The certainty and transparency provided by the framework established in the NER and applied by the AER would be compromised if rule changes were made to amend elements of the application of that framework in isolation.

Certainty and transparency are obviously desirable features of any regulatory framework and SP AusNet agrees that the existence of a certain and transparent regulatory framework is consistent with the NEO. However, a critical feature of the current regulatory framework is the ability to seek amendments to the NER where the NER are operating in a manner that is not promoting the NEO. In those circumstances, amendments to the NER may be proposed. Certainty as to a regulatory framework does not demand that the framework never changes – there have been many amendments to the NER since they commenced. Where a known error has been identified and, as discussed below, is capable of being amended without affecting other elements which may require a broader review, that error should be corrected in order to meet other important objectives, such as legitimacy and confidence in the regulatory regime.

SP AusNet does not consider that, in the current circumstances, the objective of certainty should outweigh all other considerations, including the objective of seeking to achieve the revenue and pricing principles. In particular in this case, it is important that a regulated network service provider should be provided with a reasonable opportunity to recover the efficient costs incurred by that service provider in providing regulated services.

Whilst the locking in of certain parameter values under Chapter 6A of the NER provides a high degree of certainty as to what those parameter values will be, it does not, in circumstances where a known error exists in the determination of one of those parameters values, offer certainty that a TNSP in the position of SP AusNet will be provided with a reasonable opportunity to recover its efficient costs. In the case of gamma, SP AusNet can only be certain that its corporate income tax allowance will be underestimated in the absence of any rule change. This is not the type of certainty that SP AusNet considers to be desirable.

TNSPs can only have certainty that they will have a reasonable opportunity to recover at least their efficient costs where the rate of return framework is sufficiently flexible to adapt to changing market conditions and developments in finance theory. Clearly there is no such flexibility within the current rules, and therefore a rule change is required.

The AEMC has recognised that the current framework for determining the rate of return under Chapter 6A of the NER is not satisfactory, including because too much emphasis is placed on certainty at the expense of flexibility. The AEMC has noted:⁵

The electricity transmission framework in chapter 6A is no longer appropriate, given the developments in financial markets since 2008. Even though this framework provides stability and certainty, this appears to be at the expense of a decline in the quality of the rate of return estimates for transmission NSPs over time. The approach for determining a rate of return on investment must provide a level of flexibility to reflect changing circumstances; and take into account prevailing market conditions as they vary. Increased flexibility would provide for decision making that is more attuned to changing market conditions and current approaches in financial theory.

SP AusNet agrees with this position and considers that the situation in relation to gamma is a clear manifestation of the problems with Chapter 6A that have been identified by the AEMC. As noted in SP AusNet’s submission accompanying the Proposed Rule, the AER is currently required by Chapter 6A

⁴ AEMC, *Draft Rule Determination: National Electricity Amendment (Assumed utilisation of imputation credits) Rule 2012*, 28 June 2012, p 13.

⁵ AEMC, *Directions Paper: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012; National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 2 March 2012, p v.

to adopt a value for gamma which is known to be out of step with current finance theory and which will not allow TNSPs to fully recover the cost of corporate income tax. The AEMC's consultant in the AER and Energy Users Rule Change Committee rule change proposal process has similarly noted that the inability to correct known errors in relation to gamma is a particular weakness of the Chapter 6A rate of return framework.⁶

SP AusNet notes that the AEMC may seek to address the deficiencies it has identified in the Chapter 6A framework through other rule changes. However SP AusNet is concerned that these rule changes may not be enacted in time or in an appropriate form to allow an adjustment to the value for gamma in its forthcoming transmission determination to apply from 1 April 2014. It is no answer to the Proposed Rule that amendments may be made to the NER in the future so that other TNSPs will not be in the same position as SP AusNet now finds itself in the absence of amendments being made to the NER to prevent a known incorrect value for gamma being applied in SP AusNet's revenue determination that will apply until 2018.

Unless and until any rule changes providing for greater flexibility in the Chapter 6A rate of return framework come into effect, SP AusNet submits that its Proposed Rule should be made to address the issue that has arisen in relation to gamma. The Proposed Rule provides for the minimum amendment necessary to clause 6A.6.4 of the NER, in order to provide TNSPs with a reasonable opportunity to recover their efficient costs in forthcoming regulatory periods. If the Proposed Rule is not made, the problems with the Chapter 6A framework which have been identified by the AEMC and its consultants will be perpetuated in forthcoming transmission determinations, resulting in outcomes that are inconsistent with the NEO and the revenue and pricing principles.

3 Recovery of efficient costs and investment incentives

The AEMC appears to consider that the adjustment of gamma in isolation may risk the over recovery of costs and distortion of investment incentives. The AEMC's concern appears to be that inter-relationships with other parameters would not be taken into account in this adjustment process, meaning that the resulting overall rate of return may not be appropriate. The AEMC states:⁷

...varying the value of gamma as proposed by SP AusNet and ElectraNet in the absence of analysing potential cross-linkages between gamma and the other elements may result in an underlying change in the incentive arrangements for the network businesses. This raises the risk of over recovery of costs to the detriment of end consumers of electricity.

SP AusNet acknowledges that whilst gamma does not form part of the rate of return under the post-tax revenue framework, there is potentially a relationship between gamma and the market risk premium (**MRP**) component of the weighted average cost of capital. Where estimation of the MRP is based on historical excess returns, it is generally considered appropriate to "gross up" these historical returns for the value of imputation credits.⁸

However this relationship between gamma and the rate of return has been taken into account in determining the value for gamma which SP AusNet is proposing be adopted as part of its Proposed Rule. The determination of the value for gamma of 0.25 in *Re Energex*⁹ was not made in isolation, but rather was made by the Tribunal having regard to potential inter-relationships with other rate of return parameters. As noted by the AEMC's consultant in the AER and Energy Users Rule Change Committee rule change proposal process, the issue of potential interaction with the MRP was raised before the Tribunal, and the Tribunal sought submissions from the AER specifically on this issue.¹⁰

⁶ SFG Consulting, *Preliminary analysis of rule change proposals: Report for AEMC*, 27 February 2012, [69] and [129].

⁷ AEMC, *Draft Rule Determination: National Electricity Amendment (Assumed utilisation of imputation credits) Rule 2012*, 28 June 2012, p 12.

⁸ For an example of the "gross up", refer to: AER, *Final Decision: Electricity transmission and distribution network service providers – Review of the weighted average cost of capital (WACC) parameters*, May 2009, pp 204-209.

⁹ *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9.

¹⁰ SFG Consulting, *Preliminary analysis of rule change proposals: Report for AEMC*, 27 February 2012, [138]; *Application by Energex Limited (No 2)* [2010] ACompT 7, [59].

Based on the submissions of the AER, the Tribunal determined that no consequential adjustment to the MRP was required.¹¹

Moreover, to the extent that the AER considered that any changes should be made to other parameters consequential on adopting a value for gamma of 0.25, it would be expected that the AER would have directly addressed these in the numerous recent decisions (following the Tribunal determination in *Re Energex*) in which it has adopted that value. A review of these decisions reveals that the AER has made no amendment to any other parameter consequential on the adoption of a value for gamma of 0.25, in circumstances where it clearly has the power to do so.¹²

Following the determination made by the Tribunal in *Re Energex* would contribute to the achievement of the NEO. The Tribunal stands in the shoes of the AER, and therefore must perform its regulatory functions and exercise its powers in a manner that will or is likely to contribute to the NEO and having regard to the revenue and pricing principles.¹³ In its review of the value for gamma, the Tribunal explicitly recognised the NEO and the revenue and pricing principles¹⁴ and was guided by these in making its decision.¹⁵ Therefore it is not correct to characterise the Tribunal's determination in relation to gamma as being made "in isolation" or "upsetting the balance" between competing elements such that it is unlikely to contribute to the achievement of the NEO.

In the absence of a rule change, the AER would be required to maintain a value for gamma in forthcoming transmission determinations which is known to be incorrect and which it has abandoned where it has the flexibility to do so.¹⁶ This would be inconsistent with the NEO and the revenue and pricing principles, since it would ensure that SP AusNet would not have a reasonable opportunity to recover its efficient costs (and in particular its cost of corporate income tax).

4 Appropriateness of AEMC making adjustments to gamma

The AEMC considers that a review of parameters such as gamma should be undertaken by the AER, and that it is not appropriate for the AEMC to undertake this role.

SP AusNet is not seeking an independent review of the gamma parameter by the AEMC. A comprehensive review of the evidence in relation to gamma has already been conducted by the Tribunal, standing in the shoes of the AER and taking into account relevant interactions with other parameters.¹⁷ The outcome of this review has been accepted by the AER, and adopted in recent determinations under the National Gas Rules and Chapter 6 of the National Electricity Rules.¹⁸

SP AusNet is seeking a simple rule change which allows for a once-off adjustment to the value for gamma to update it in line with the Tribunal's review. For the reasons set out above and in SP AusNet's previous submission accompanying the Proposed Rule, this amendment would contribute to the achievement of the NEO.

¹¹ *Application by Energex Limited (No 2)* [2010] ACompT 7, [59].

¹² AER, *Final Distribution Determination: Aurora Energy Pty Ltd 2012–13 to 2016–17*, April 2012, p 112; AER, *Final decision: Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011 – 30 June 2016*, June 2011, pp 61-62.

¹³ NEL, s 16(1).

¹⁴ *Application by Energex Limited (No 2)* [2010] ACompT 7, [9]-[12].

¹⁵ *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9, [37].

¹⁶ In several recent determinations under the National Gas Rules and under Chapter 6 of the National Electricity Rules, the AER has adopted a value for gamma of 0.25 (AER, *Final Distribution Determination: Aurora Energy Pty Ltd 2012–13 to 2016–17*, April 2012, p 112; AER, *Final decision: Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011 – 30 June 2016*, June 2011, pp 61-62).

¹⁷ A summary of the Tribunal's review, including the evidence it took into account, is provided in ElectraNet's submission accompanying its Proposed Rule (ElectraNet, *ElectraNet Rule Change Proposal – Gamma*, 30 November 2011).

¹⁸ AER, *Final Distribution Determination: Aurora Energy Pty Ltd 2012–13 to 2016–17*, April 2012, p 112; AER, *Final decision: Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011 – 30 June 2016*, June 2011, pp 61-62.