Independent Pricing and Regulatory Tribunal

IPART
New South Wales

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Mr John Pierce
Chairman
Australian Energy Market Commission
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Dear ~~Mr Pierce~~ John

NATIONAL ELECTRICITY AND GAS RULES - PROPOSED RULE CHANGES TO THE ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS

The Independent Pricing and Regulatory Tribunal of NSW (IPART) has prepared the attached submission on the changes to National Electricity and Gas Rules (Rules) proposed by the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC). The submission is in two parts: the first section addresses the Rule changes proposed by the AER; the second section addresses the Rule changes from the EURCC.

We have stated over a number of years our concerns about the impact of higher electricity prices on affordability, particularly for vulnerable customer groups, and that the current regulatory arrangements are promoting investment in excess of efficient levels. As we have observed prices for small retail customers in NSW have increased by 66% in nominal terms over the past 5 years, which equates to an average annual increase of 13%, and these increases have primarily been driven by a significant growth in network costs. While we do not have direct measures we expect that there have been similar impacts on larger electricity customers in NSW.

These network costs increases may have been higher than necessary due to certain aspects of the regulatory framework, including the economic regulation of the networks under the Rules. We have specifically called on the AEMC to conduct a review of the Rules to address concerns that they may bias the AER's decisions in favour of higher network prices and inefficient outcomes at the expense of electricity customers.

We consider that the current regulatory arrangements are putting upward pressure on network prices. This flows through to higher retail prices and customer bills. The current arrangements:

- constrain the AER's ability to apply what it considers to be the best estimate of the efficient operating and capital costs

- provide strong incentives for network business to invest capital in the network because the prescriptive requirements of the Rules may lead to excessive returns
- allow the businesses to earn a return on all capital invested regardless of its efficiency and prudency, by requiring the AER to roll all capital expenditure into the asset base
- provide opportunities for the businesses to target particular issues through the appeal process.

Therefore, we generally support the Rule changes proposed by the AER.

We are grateful for the opportunity to contribute to this important review. If you have any further questions on our submission please contact Fiona Towers on (02) 9290 8420.

Yours sincerely

James Cox

James Cox PSM
Chief Executive Officer
and Full Time Member

National Electricity Amendment (Economic regulation of network service providers) Rule 2011 and National Gas Amendment (Price and revenue regulation of gas services) Rule 2011

Part 1: Rule changes proposed by the AER

1. The problem

In its consultation paper the AEMC asked the following:

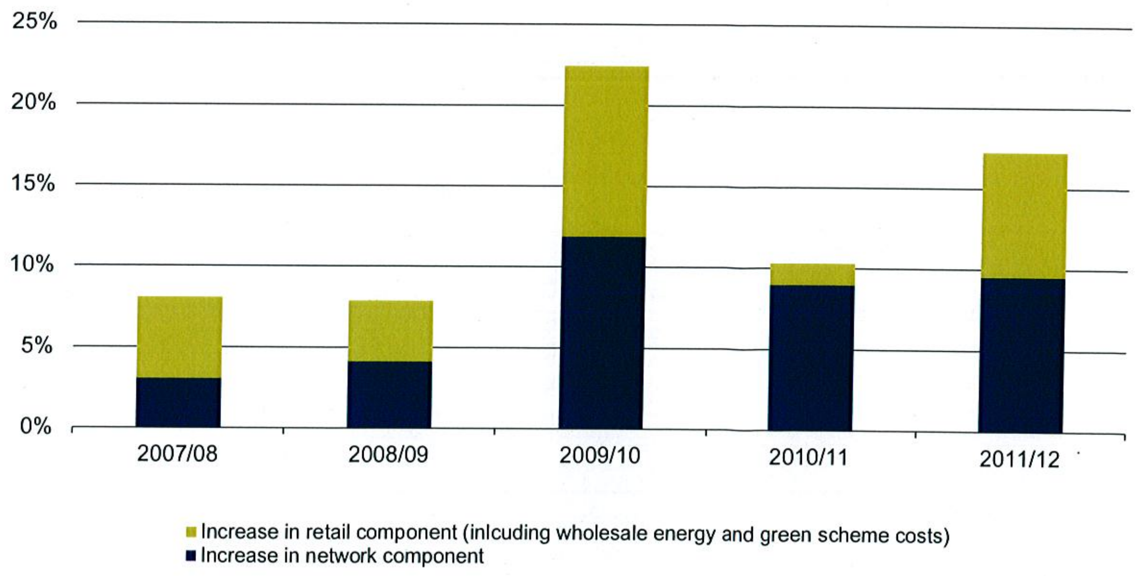
Do you agree with the extent of the problems with the framework for economic regulation of electricity and gas networks as characterised by the AER? We would also welcome views and analysis on the effectiveness of the current rules as they have been applied over the last five years.

We agree that the economic framework is a significant problem and the extent of the problem may have been understated by the AER.

IPART's major concern with the current Rules is the impact of recent network price increases on electricity prices for electricity consumers in NSW. Our view is that the current Rules may not be promoting outcomes which are in the long-term interests of customers.

The nominal increases in NSW electricity prices since 1 July 2007 are presented in Figure 1.

Figure 1 Average increases in NSW electricity prices for small retail customers 2007/08 to 2011/12 ($ nominal)

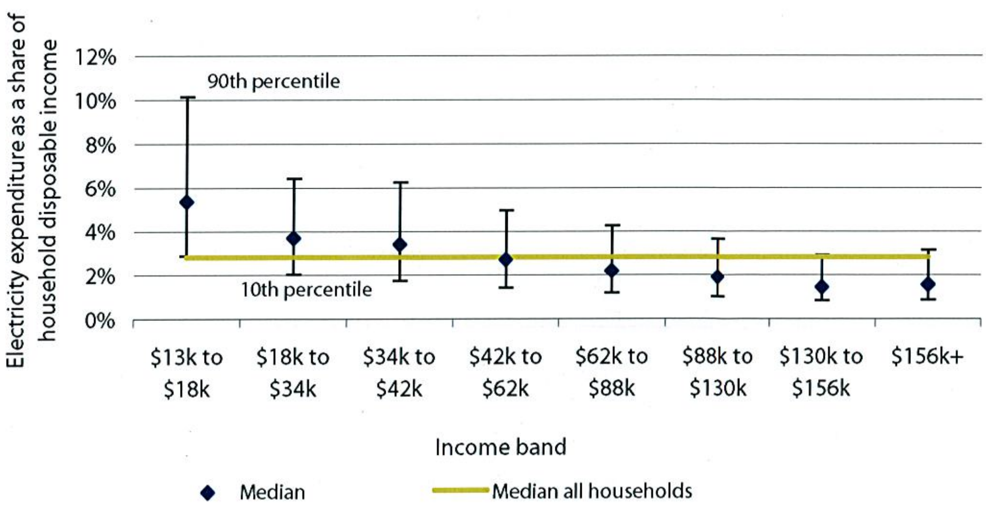


As Figure 1 demonstrates the majority of the increase in electricity prices has been driven by increasing network costs. The network component of retail electricity bills has increased by 37% in nominal terms over the past 5 years, which equates to an average annual increase of 7.5%. Over the last 3 years the network component has increased by a nominal annual average of 10% driving a 16.5% average increase in retail prices over the same period.

In our recent reviews we have used the proportion of household disposable income spent on electricity as a measure to assess how these prices increases have affected electricity affordability. Our analysis indicates that, for Sydney and surrounding areas, the vast majority of household's electricity bills are likely to make up 4% or less of their disposable income but affordability is becoming a key concern for some vulnerable groups of customers.

For example, while households with disposable incomes below $18,000 a year spend on average just over 5% of their income on electricity, there is a large variation in how much of their disposable income they are paying for electricity bills. Some high consumption households are paying more than 10% of their income on electricity (see Figure 2).

Figure 2 Electricity bills as a share of disposable income, Sydney and surrounding areas, 2011/12



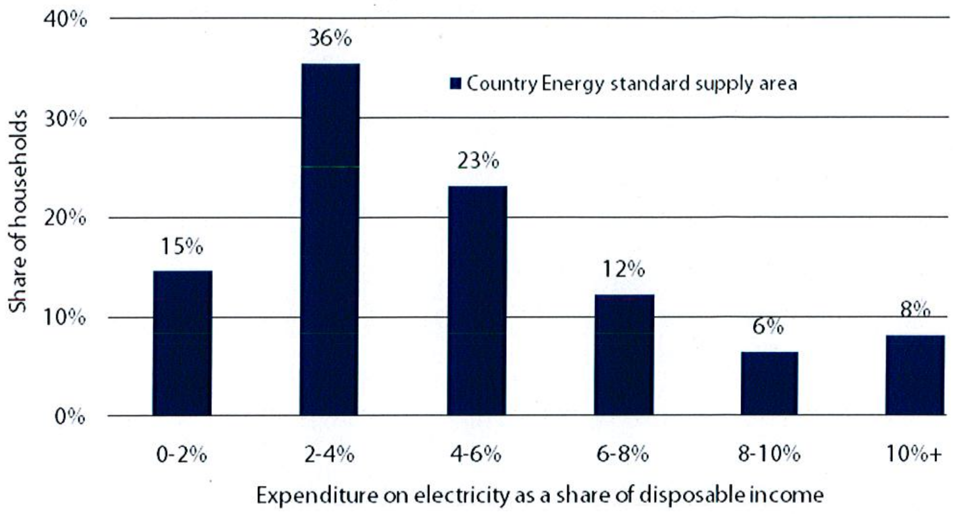
Note: The income bands are before tax income in 2010. The income for the middle of each band is used to calculate disposable income. Disposable income as a share of household income is derived from ABS household income distribution data for 2007/08. Incomes for all bands are presumed to rise by 3.9% in 2011/12, in line with the average increase that has occurred over the past 5 years. Distributions are presented without weighting survey responses.

A **percentile** is the value below which a certain percentage of observations fall. For example, the 10th percentile is the value below which 10% of the observations may be found. In the above diagram, 10% of customers in each income band would fall below the bottom of the vertical line (paying less than that amount) and 10% of customers would pay more than the top of the vertical line.

Data source: IPART Household Surveys, 2010 and 2008.

We have also estimated the impact on affordability in country NSW where recent electricity price increases have been more significant. This analysis shows that around 8% of households spend more than 10% of their disposable income on electricity (Figure 3).

Figure 3 Electricity bills as a share of disposable income — outside Sydney 2011/12



Note: Distribution based on Sydney distribution adjusted to reflect median income and median electricity bills in each postcode in Country Energy's standard supply area.

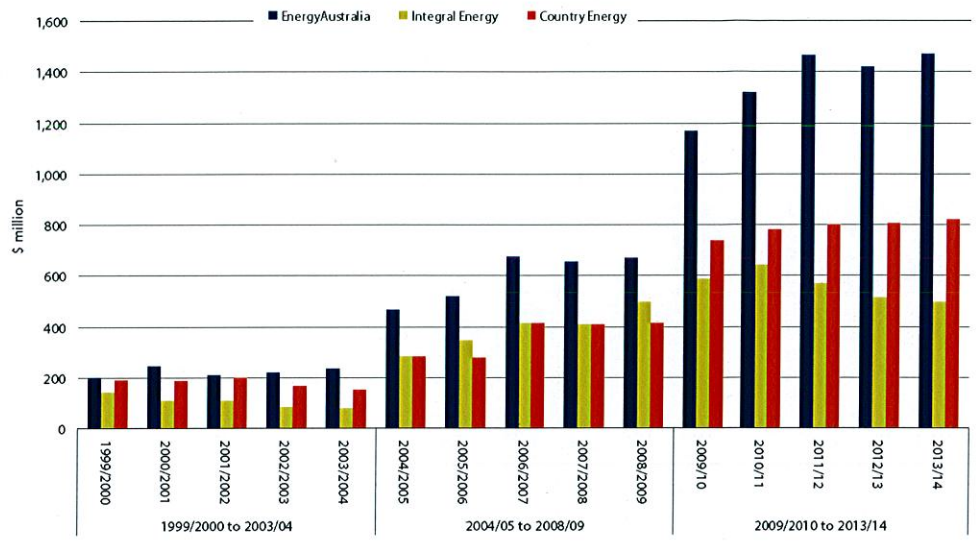
Data source: ABS Census 2006, Table B02, item B112; Country Energy billing data; ABS Catalogue No. 6302.0: Average weekly earnings, Australia, November 2010; IPART analysis.

We consider that network costs increases, which are responsible for most of the recent price increases, may be higher than necessary due to certain aspects of the regulatory framework which is contributing to inefficient outcomes. We consider that the current regulatory arrangements are putting upward pressure on network prices. This flows through to higher retail prices and customer bills. The current arrangements:

- constrain the AER's ability to apply what it considers to be the best estimate of the efficient operating and capital costs
- provide strong incentives for network business to invest capital in the network because the prescriptive requirements of the Rules may lead to excessive returns
- allow the businesses to earn a return on all capital invested regardless of its efficiency and prudency, by requiring the AER to roll all capital expenditure into the asset base
- provide opportunities for the businesses to target particular issues through the appeal process.

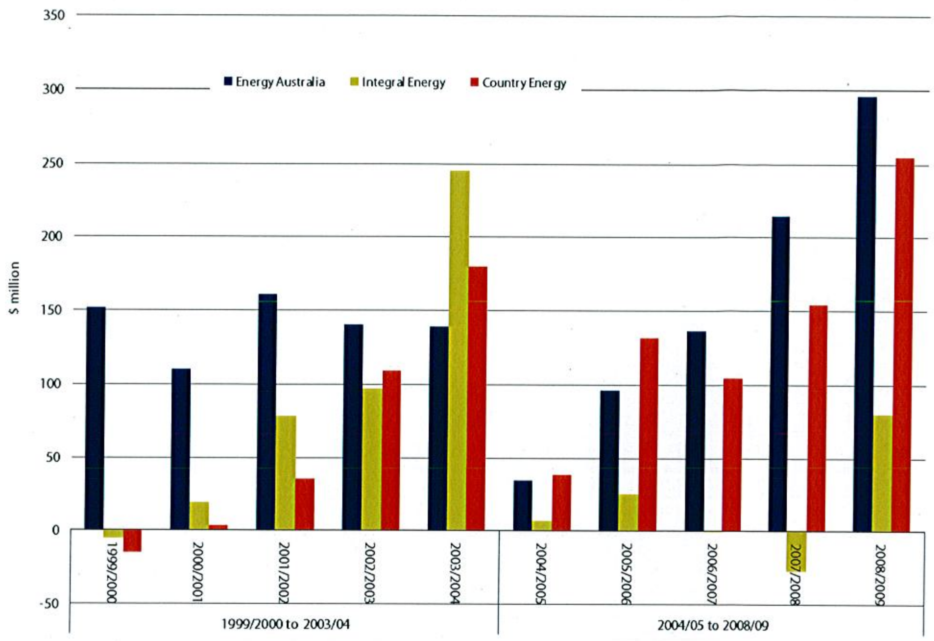
Our analysis shows that the allowed expenditure levels under the current Rules are significantly above the levels under the previous regulatory framework, particularly for capital expenditure in NSW (see Figure 4).

Figure 4 Capital expenditure allowances in regulatory determinations for NSW distribution businesses ($2009/10)



In addition, in the last 3 years of the 2004/05 to 2008/09 regulatory period, the NSW distribution businesses' actual capital expenditure was significantly higher than the regulatory allowances, which are determined prospectively (see Figure 5). For example, EnergyAustralia invested over $500m in capital per annum in excess of the regulatory allowances in the 2007-2009 period. It should be noted that the regulatory allowances in the 2004/05 to 2008/09 period were largely based on the proposals submitted by the businesses. That is, not only did the businesses spend considerably more than allowed, they spent considerably more than they said they would spend to the regulator.

Figure 5 Difference between actual capital expenditure and regulatory allowances by NSW distribution business (overspends are positive amounts) ($2009/10)



In part the higher expenditure levels reflect the NSW distribution businesses obligations to meet reliability of supply conditions imposed by the former NSW Government which are subject to a separate AEMC review.

We are of the view that the cumulative effect of the economic regulatory provisions of the Rules is rapidly increasing network prices, which flow through to retail prices and customer bills. In our view, the current regulatory framework:

- constrains the AER's ability to apply what it considers to be the best estimate of the efficient operating and capital costs
- provides strong incentives for network business to invest capital in the network because the prescriptive requirements of the Rules may lead to excessive returns
- allows the businesses to earn a return on all capital invested regardless of its efficiency and prudency, by requiring the AER to roll all capital expenditure into the asset base
- provides opportunities for the businesses to target particular issues through the appeal process.

The objective of the National Electricity Law (NEL), which governs the AEMC's considerations in making Rules changes, is:

> ...to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –
>
> - price, quality, safety, reliability, and security of supply of electricity; and
> - the reliability, safety and security of the national electricity system.[1]

We are concerned that the current regulatory arrangements may not best meet this NEL objective because they could be promoting investment in excess of efficient levels. Paying higher prices than necessary is not in the long-term interest of customers.

2. Prescription and discretion

In its consultation paper the AEMC asked the following:

Rules that are more prescriptive set out more detail around the how the AER makes its decisions. Rules that allow for more discretion give the AER more scope to decide for itself how decisions are to be made. Have the proposed Rules achieved the right balance between prescription and discretion?

We agree that the revised Rules proposed by the AER better balance prescription and discretion.

Under the Rules, the AER is precluded from making a decision that it considers to be its *best* estimate of a business' efficient costs. This is because the AER must accept the spending forecasts proposed by the network companies if it is satisfied that the proposals "reasonably reflect" efficient, prudent and realistic costs.[2]

We consider that this is placing an unusually high burden of proof on the regulator. For example, the Australian Competition Tribunal, in deciding an appeal by AusGrid (previously EnergyAustralia) against the AER's decision on operating expenditure for the 2009/10-2013/14 period, highlighted the nature of the AER's role in making decisions. The Tribunal stated:[3]

[1] National Electricity Law, s7.

[2] National Electricity Rules, clauses 6.5.6(c) and 6.5.7(c).

[3] Australian Competition Tribunal, Application by EnergyAustralia and Others (includes corrigendum dated 1 December 2009) [2009] ACompT 8 (12 November 2009, last updated 4 December 2009), s190.

Clause 6.5.6(c) of the Transitional Rules[4] is clear – the role of a DNSP is to provide the AER with an opex forecast that reasonably reflects the three opex criteria and the AER must accept the forecast if it is satisfied that the total of the forecast reasonably reflects the three criteria. **EnergyAustralia is correct to submit that it is not the AER's role to simply make a decision it considers best.** [Emphasis added] It is also correct for it to say that the AER should be very slow to reject a DNSP's proposal backed by detailed, relevant independent expert advice because the AER, on an uninformed basis, takes a different view. Nor, as EA submits, may the AER reject such a proposal merely because it has an expert opinion.

In practice, there is often a wide range of reasonable estimates for a business' operating and capital expenditure requirements. Under the Rules, if a business presents a spending proposal that lies in the upper bound of that range, which it has every incentive to do, the AER must approve it if it satisfied that it is "reasonable," even though its best estimate is a lower forecast. If the AER refuses to approve expenditure proposed by a network company, it can only amend that expenditure to the **minimum extent necessary** to enable it to be approved in accordance with the NER.[5] This brings the expenditure within the reasonable range of estimates, but it may not impose the AER's best estimate of efficient costs.

The effect of these Rules is that it is difficult for the regulator to provide a balanced determination. The AER notes:[6]

> The rules currently require the AER to accept proposals from NSPs if it is satisfied they 'reasonably reflect' efficient, prudent and realistic expenditure. The expression 'reasonably reflects' recognises that there may be more than one expenditure forecast that is efficient, prudent and realistic. Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leaves the evidentiary burden on the AER to prove that the proposed forecast does not reasonably reflect prudent and efficient costs. Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operate to exclude the AER from setting that lower forecast. In an unbiased regime, all answers that meet the requirements of the NEL could be determined. That is not the case under the current rules.

We consider these aspects of the current Rules create risks of bias towards higher network prices rather than balanced and efficient prices, and outcomes favouring the commercial interests of the monopoly businesses rather than customers' interests and efficient overall outcomes. Further, we consider that the Rules should be amended to address this issue and therefore support the AER's proposed changes.

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4 Clause 6.5.6(c) of the 'Transitional Rules' is identical to Clause 6.5.6(c) of the National Electricity Rules.

5 Clause 6.12.3(f) of the National Electricity Rules.

6 Australian Energy Regulator, *Rule change proposal Economic regulation of transmission and distribution network service providers AER's proposed changes to the National Electricity Rules,* September 2011, p 13.

3. AER's use of discretion

In its consultation paper the AEMC asked the following:

Among other things, the proposed Rules would give the AER greater discretion to assess and respond to capital and operating expenditure proposals. Could the AER instead achieve the same outcomes through greater use of the discretions it currently has, avoiding the need for expanding these discretions?

We consider that the AER cannot change its use of discretion in practice without a change to the Rules.

Our comments in response to the previous question explain how the current Rules effectively constrain the AER's decision making. We are also of the view that any discussion of regulatory discretion must consider the entire regulatory framework and how this affects the AER's decision making. In particular it is important to consider how the merits review process affects any discretionary decisions the AER makes.[7]

The review process provided by the NEL allows the network businesses to seek review of specific aspects of the AER's determination to achieve more favourable outcomes. The review process involves the Australian Competition Tribunal reconsidering the merits of the AER's decision. This review is limited to particular grounds and can only be made with the Australian Competition Tribunal's leave. We recognise that a limited merits review - in contrast to a wholesale (de novo) review - has the benefit of focusing on the issues in dispute. However, it means that the Australian Competition Tribunal is not able to properly consider the merits of individual component decisions in the context of the AER's whole determination, or the effect that modifying these decisions may have on outcomes, in particular electricity prices.

Therefore, the Australian Competition Tribunal cannot consider, for example whether the businesses will still face appropriate incentives regarding infrastructure investment from other aspects of the AER's decision.

In making its pricing determinations, the AER has interpreted and applied the Rules. A number of elements of the AER's original decisions have been appealed. Where those appeals were successful, the AER has then amended its regulatory precedent to account for the Australian Competition Tribunal's decisions.

Therefore, it is not only the AER's interpretation of its discretion, but the Australian Competition Tribunal's interpretation that guides the AER's decision making.

7 We understand that the merits review framework is not being considered by the AEMC as part of this review. Nevertheless the Rules need to be considered within the wider regulatory framework, including merits review.

Further, by applying a consistent approach to decision making, regulators provide certainty. It would be difficult for the AER to substantially alter its approach to decision-making without a change to the Rules.

Therefore, we consider support the AER's proposed changes.

4. The solution

In its consultation paper the AEMC asked the following:

On the basis of the problems raised by the AER, are there any more preferable solutions to those problems? Please note that the AEMC may only implement Rule changes that respond to the problems raised by the AER, and it may not consider proposed changes that respond to other problems raised in submissions.

We support the AER's overall proposal, but consider that it should be supplemented with an ex-post review of expenditure.

We consider that the AER's proposed package of Rule changes addresses many of the key concerns with have with the existing regulatory framework. In particular it provides:

- greater discretion for the AER to apply what it considers to be the best estimate of the efficient forecast operating and capital expenditure
- stronger incentives to invest capital efficiently.

While we support the overall package of Rule changes proposed there are other possible mechanisms to address the problems identified by the AER, particularly in providing incentives to the network service providers (NSPs) to spend within expenditure forecasts.

For example, the AER has proposed a sharing mechanism for capital overspends as a way of increasing the strength of the incentive to spend within expenditure forecasts. The AER's argues that a 60 (customer)/40 (shareholder) funding split of any capital overspend is consistent with the outcome that would arise under a capital expenditure rolling incentive. While we concur with the AER that its proposed sharing mechanism does have advantages over a rolling incentive including its simplicity, we note that rolling incentive frameworks have been successfully used by other regulators and therefore could provide an appropriate mechanism for the AEMC's consideration.

Another option that the AEMC could consider is the use of ex-post prudency assessments prior to rolling capital expenditure into the asset base as utilised under the National Gas Rules. We have previously expressed our view that ex-post reviews assist in ensuring network business have the incentive to ensure that their actual capital expenditure is efficient or prudent and valued by the customer.

We recognise that any ex-post review needs to be appropriately defined, but having regulated distribution businesses under an ex-post review framework, we are confident that it works in practice without materially jeopardising investment certainty, particularly under a well-designed framework. For example, the ex-post review could ensure that in making investment decisions, the businesses applied a rigorous expenditure approval process, which could be specified in a guideline.

In 2010 IPART commissioned PricewaterhouseCoopers to undertake a comparative analysis of the design, application and impact of regulatory tests for capital expenditure that we and other regulators use, including the observable impact on incentives for efficiency and investment risk. This report acknowledged the informational disadvantage of the regulator and focused on whether regulators should undertake capital expenditure reviews. It identified the importance of testing:[8]

> Whether the 'need' for investment was properly articulated, the full range of options and sensitivities were considered and the process for assessment and delivery was consistent with best practice, including that risks were identified and appropriately managed.

PricewaterhouseCoopers made the following comments on the international experience of ex-post reviews:[9]

> Even in the UK, where financial incentives for cost-efficiency are the most developed and it has been more than 25 years since their major privatisation, the water and energy regulators retain the discretion to undertake an ex post review of efficiency and disallowances have occurred. The US has been regulating privately owned infrastructure firms for more than a century, and yet administrative testing of the efficiency of capital expenditure remains a central component of the regime.

Further, the Rules will apply to both publicly and privately owned network businesses. It is appropriate to include a range of mechanisms to allow the most effective mechanism given the ownership and governance arrangements of these businesses. Therefore, we consider that the AEMC should consider including both the sharing mechanism and ex-post reviews in the Rules.

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8 PricewaterhouseCoopers, *Review of Regulatory tests for capital expenditure, Final Report*, 10 August 2010, p 5.

9 PricewaterhouseCoopers, *Review of Regulatory tests for capital expenditure, Final Report*, 10 August 2010, p 13.

Part 2: Rule changes proposed by the Energy Users Rule Change Committee (EURCC)

1. Excessive profits to NSPs

In its rule change request, the EURCC has attempted to quantify what it considers "excessive profits" being made by NSPs as a result of higher return on debt allowances than their actual cost of debt (section 2.3.1 and Appendix 1 of the rule change request). It also suggests that State Governments receive these profits as well as the tax on those profits from the NSPs that they own.[10]

In its consultation paper the AEMC asked the following:

Stakeholders are encouraged to comment on the excessive profit analysis presented in the rule change request including the data on actual cost of debt estimates and indicate whether they agree or disagree with the propositions put by the Energy Users Committee

We do not agree with the EURCC. The loan guarantee fees are in our view part of the reasonable cost of debt. We understand that in NSW, T-Corp sets its loan guarantee fee with reference to current market rates of a borrower's credit rating. In principle, this is a 'fee-for-service' rather than an excess profit.

We consider that the retention of company tax by the state governments does create a distortion. It provides additional income for the owning state government that could in principle provide an incentive for the government to encourage – or at least not discourage – overinvestment. But the preferred option to address this 'wedge' is through the inter-governmental revenue sharing arrangements rather than distorting prices and, hence, consumption decisions.

2. Options for estimation of the Debt Risk Premium

In its consultation paper the AEMC asked the following:

...whether the measures of debt costs identified by the Energy Users Committee are the appropriate benchmarks for government-owned and privately owned NSPs.

We consider that a number of the options proposed by the EURCC such as the indexing of cost of debt to a rolling average proposed for privately-owned networks have merit. In our opinion, the EURCC has provided evidence that suggests current prescribed benchmarks under the NER have over-estimated the cost of debt for the regulated energy networks. We believe that it would be worthwhile to further explore the options proposed in the CEPA

[10] AEMC Consultation Paper, *Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011*, 3 November 2011, p.9.

annex. While we would prefer to use a benchmark approach to preserve incentives to pursue more efficient structures, if an appropriate benchmark cannot be found, debt costs could be passed through at actual costs. However this would not be consistent with economic efficiency (see comments below).

We also consider that rather than mandating the approach we believe that it is best left to the discretion of the AER to decide on the appropriate methodology to determine the cost of debt within the requirements of the WACC/CAPM principles and subject to the possibility of merits appeal.

3. Differentiating the cost of debt by ownership

The EURCC outlined arguments for why it believes it is justifiable for government-owned NSPs to be treated differently to privately owned NSPs in determining the return on debt. These include analysis on:

- competitive neutrality
- compensation for diversification
- capital market discipline
- compensation for access to government's credit rating.

In its consultation paper the AEMC asked the following:

Stakeholders are encouraged to comment on implications for competitive neutrality in the context of the Competition Principles Agreement arising from treating government-owned NSPs differently to privately owned NSPs. What other issues should be considered?[11]

We consider that government-owned businesses should be treated the same way as privately-owned businesses on the grounds of:

1. economic efficiency
2. consistency in the application of cost of capital principles to the cost of capital.

Firstly, we consider that the argument for setting prices independent of ownership is not limited to competitive neutrality in output markets. Even monopolies compete for economic resources. In principle the resources embodied in the assets of an electricity or gas network have the same resource costs (opportunity cost) irrespective of ownership. Pricing of the services in a way that does not fully reflect those costs will:

a. promote excessive demand for the services

[11] AEMC Consultation Paper "Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011" 3 November 2011, p.10.

b. to the extent investment is not discretionary, it will discourage efficient levels of investment, resulting in a shortfall in capacity and poorer standards of service

c. to the extent investment is non-discretionary, it will encourage excess investment to meet the higher demand levels.

Over-pricing will have the opposite effect. Both are to be discouraged.

Secondly, if there is a distinction in the cost of capital on the basis of ownership why should this be limited to the cost of debt only? This would seem to lead to an inconsistent treatment of debt and equity as the cost of equity will also differ between owners based on tax status.