AEMC Public Forum

Economic Regulation of Networks Rule Change Proposals

23 November 2011

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No easy solution to rising prices

"We need outcomes that are based on sound policy formulation and proper cost benefit analysis, rather than dogma and ideology … there are no easy solutions in the face of increasing electricity prices.

Keeping prices artificially low is not the solution.

History has shown that this only leads to more concentrated periods of price increases."

Source: Federal Energy Minister Martin Ferguson speaking at Energy Users/ Consumers conference in Canberra, 13 September 2011

Getting the investment balance right

"Energy networks play a crucial role in bringing reliable energy to households and businesses – they are the foundation of our modern economy"

"Figures around recent and projected price rises are regularly cited in media reports

What is less frequently mentioned are the costs to consumers and the costs to business from a lack of reliability because of underinvestment.

Lack of reliability in our electricity supply would threaten jobs, threaten business and undermine our economic prosperity.

This is why it is so important to get the balance right, why it is vital that we don't stand in the way of required investment…"

Source: Martin Ferguson speaking at ENA Smart Networks Summit, 18 May 2011

Presentation overview

- Rationale for current arrangements
- How well have these worked?
- Initial views on the proposed Rule changes (using AEMC assessment framework)

Rationale for current arrangements

1. **Productivity Commission 2002:**

   "**Investments in essential infrastructure will also be deterred if regulated terms and conditions are not expected to provide a sufficient return**. …..Regulatory pricing arrangements that (inadvertently) appropriate upside returns… can be a significant source of inefficiency arising from access regulation."

2. **Prime Minister's Export Infrastructure Task Force 2005:**

   "Streamlining and better defining the objectives that regulators should pursue would help address the risks and difficulties the current situation gives rise to. To begin with, **regulators should, as their primary duty, be required to ensure that efficient investment in Australia's infrastructure occurs**, and occurs in a manner consistent with the continued, reliable and secure provision to the community of the services that infrastructure provides."

3. **AEMC 2006:**

   "Increasing the clarity, certainty and transparency of the regulatory approach, so as to **provide a more certain regulatory environment in which investors can make efficient investment decisions** which deliver market outcomes that better serve the long term interests of consumers."

[Emphasis Added]

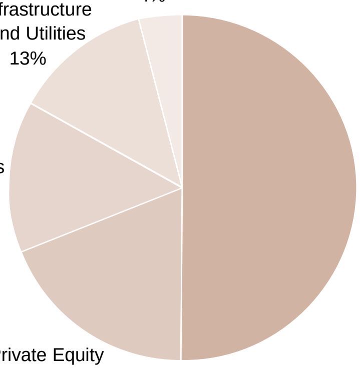
Australian utilities compete for capital in a global market

Utilities compete for capital with other 'Alternative' assets…

…. from fund managers all over the world……

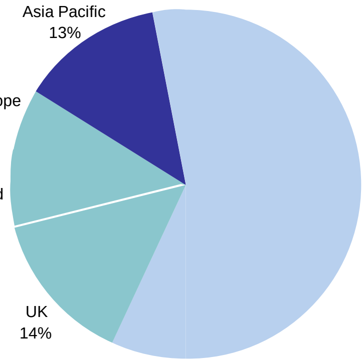
…. who invest all over the world

Alternative Assets (% held by top 100 managers)

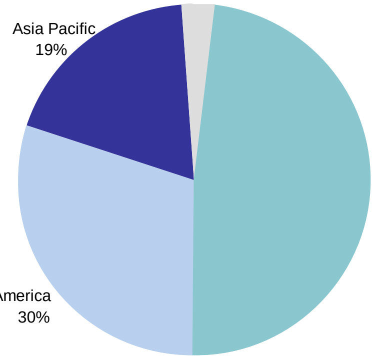


Total A$2,312bn

Top 100 Alternative Asset Managers (% by domicile)



Infrastructure & Utilities (% invested by top 100 alternative managers)



Total A$226B

Source: David Bartholomew (CEO, DUET Group) speaking at ENA Regulatory Seminar, 27 July 2011

“Equity is <u>always</u> constrained”

- Equity does not ‘flow’ because the regulated WACC is ‘right’
- Utilities are always under pressure to deliver cash yield
- Retention of cash to fund growth and/ or commitment of new equity requires a compelling investment case to be made
- The individuals making these decisions will assess…
  - relative return and risk – short term and long term
  - short term liquidity and cash requirements
  - portfolio re-balancing imperatives

“Regulated returns are usually sufficient to maintain an investment in a defensive stock ... but often insufficient to attract new capital”

Source: David Bartholomew (CEO, DUET Group) speaking at ENA Regulatory Seminar, 27 July 2011

grid australia
BACKBONE OF THE NEM

What investors want

- A clear and relatively stable framework within which the economic regulator operates; i.e. guided discretion
- Processes for holding the economic regulator accountable for its performance
- Ability to have major regulatory errors reviewed and rectified
- They don’t want ‘political’ economic regulation…
  - where the regulator can and does respond to short term political drivers to expropriate value

Key features of current arrangements

- NEO and Revenue and Pricing Principles in the Law
- Separation of roles for policy making (SCER), Rule making (AEMC) and economic regulation/ Rule enforcement (AER)
- Rules Chapter 6A for transmission…
  - provides 'inertia' to changing arrangements but ability to innovate where benefits can be demonstrated (Rule change process)
  - provides guided discretion for the AER
  - can be amended over time subject to meeting the NEO and Revenue and Pricing Principles
- Limited Merits Review
  - AER is held accountable and errors can be corrected

What is working? It is early days!

Financial Year	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Powerlink								
ElectraNet								
SP AusNet								
TransGrid								
Transend								

Current Control Period - Completed Years

Current Control Period - Years Still to Complete

What is working for transmission?

- Required transmission investment is occurring…
  - augmentations
  - replacement capex surge to address ageing assets
- Companies are responding to incentive schemes…
  - efficiency benefit sharing scheme for opex
  - service outcomes, including market impact incentive scheme

What is not working so well?

- Major issues with the WACC setting process…
  - e.g. Chapter 6A requires the AER to continue to apply an erroneous value of gamma which can only be rectified via a Rule change (5-yearly WACC review set gamma at 0.65 but Tribunal found this to be in error and set at 0.25 – errors were later conceded by the AER)
  - no clear process for addressing GFC type events in transmission; e.g. distortion of the cost of equity due to using ‘depressed’ spot rate parameter (Rf) in conjunction with long term average (MRP) parameter in CAPM
    (ROE = Rf + Beta * MRP)
- Improvements possible to the design of the capital expenditure incentive scheme

Problems characterised inaccurately in Rule change proposals

- **Example 1** – "AER is constrained in its ability to adjust forecast capex and opex"
  - not consistent with practice in transmission (see next slide)
  - not raised as an issue in any transmission decision
  - transmission Rules (chapter 6A) differ from distribution Rules (chapter 6)
- **Example 2** – the reasons for merits review appeals are GFC and AER errors, not 'cherry picking'
- **Example 3** – claims that TNSPs overspend in response to high WACC and automatic 'roll in' of spending.
  - no evidence to suggest this is actually happening

AER headline adjustments to transmission forecasts

Company	AER Final Decision compared to company forecasts	
	Capex	Opex
ElectraNet	-11%	-9%
SP AusNet	-6%	-11%
TransGrid	-17%	-8%
Transend	-10%	-5%

Note:

1. Powerlink forecasts were strictly not subject to Chapter 6A arrangements
2. Some headline cuts in forecasts may have been allowed elsewhere in revenue determination

Source: AER current revenue determinations

"Further, given the scope of new infrastructure that is proposed for South Australia over the coming years, the investment by ElectraNet over the next regulatory control period should ensure the electricity network is well placed to meet the potential increase in demand without jeopardising reliability.“

(Steve Edwell, AER Chairman, April 2008)

No evidence of overspending

- All Grid Australia members are spending at or below the forecast capital expenditure needs…
  - consistent with load growth below original forecasts
- All Grid Australia members are spending at or below the forecast operating expenditure needs
  - consistent with the incentives provided by the Efficiency Benefit Sharing Scheme
  - influences the subsequent period forecasts resulting in sharing of efficiency gains with customers

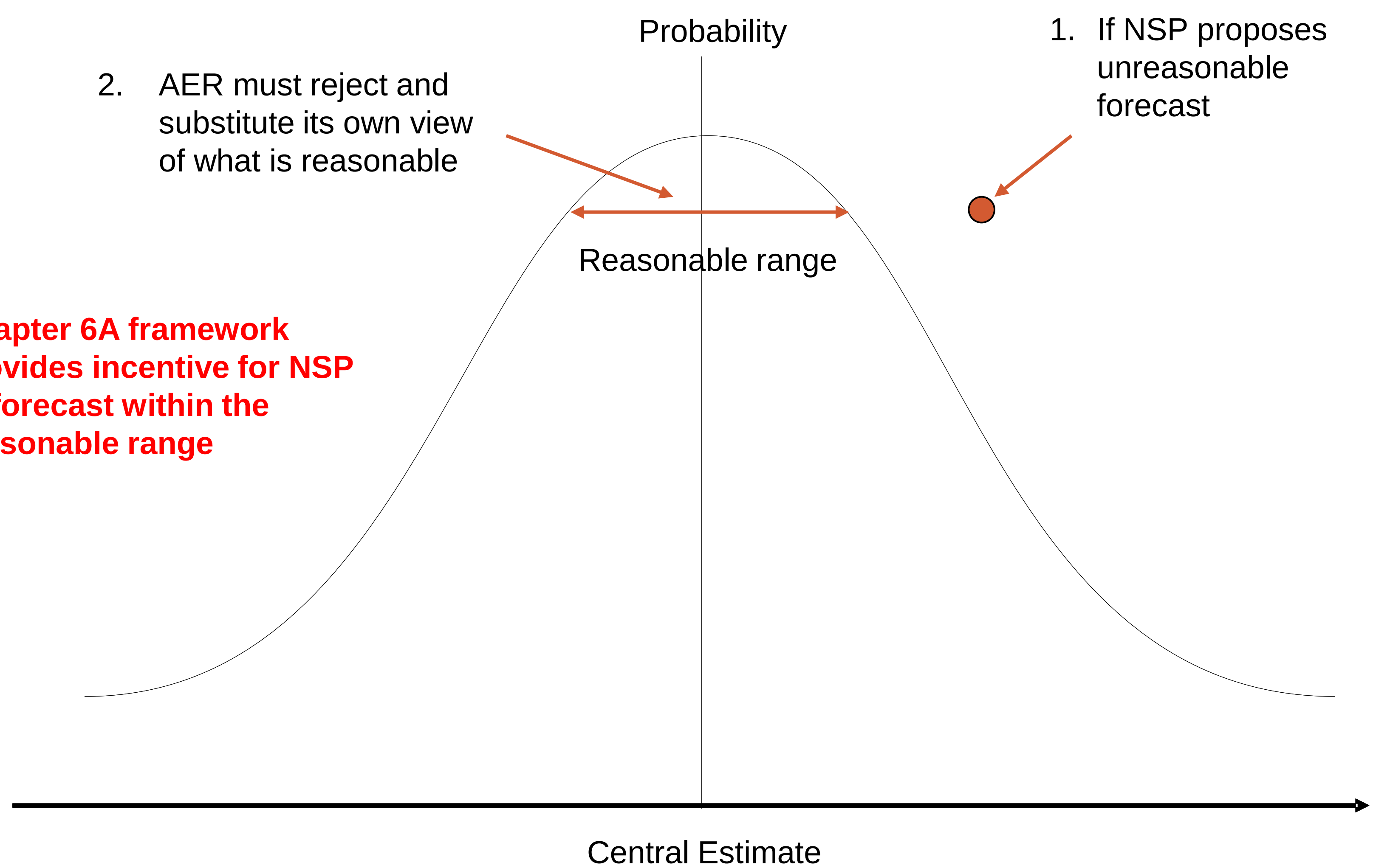
Prescription and discretion

- Current Rules do need some rebalancing…
  - sometimes too prescriptive (e.g. debt risk premium)
  - sometimes too loose – no guidance on development of WACC parameters in 5-year reviews
- Rule change proposal is calling for more discretion but in places seeking an unreasonably high level of prescription (e.g. capex incentive scheme)
- Crucial to retain effective guidance for economic regulation in the Rules…
  - provides investor certainty
  - effective and transparent process for change
  - in association with decision review processes retains ‘performance accountability framework’ for AER

Does the AER already have the required discretion to fix problems?

- In some cases 'yes'…
  - AER has discretion to reject and substitute transmission expenditure forecasts if they are unreasonable (see next slide)
  - no impediment to the application of benchmarking – generally features in transmission decisions already
- In some cases 'no'…
  - for transmission the AER is unable to implement changes to capex incentive framework as it can for distribution
- Note: AER hasn't used its existing powers under Chapter 6 Rules to address its concerns on capex incentives for distributors

AER's discretion to substitute an expenditure forecast (chapter 6A)



Chapter 6A framework provides incentive for NSP to forecast within the reasonable range

Possible Solutions?

- Early days – must be clear on problems first!
- In some instances 'solutions' may be relatively straight forward…
  - e.g. could extend the transmission model for forecasting expenditure needs to distribution?
- In other cases 'solutions' will require more thoughtful development based on evidence and expert input; e.g.
  - harmonising WACC setting arrangements
  - achieving the best balance between guidance and discretion
  - ensuring capex incentives do not undermine achievement of reliability obligations and comply with the Revenue and Price Setting Principles in the National Electricity Law

Summary

- Investor certainty still relevant
- Guided regulatory discretion still a crucial feature
- There are some issues with transmission arrangements e.g. WACC setting framework
- Facts suggest problems are often different than characterised in the Rule change proposals
- AEMC four steps framework helpful in working through the Rule change process – must be evidence based with reference to the NEO and Revenue and Price Setting Principles
- Extended consultation period important and appreciated