



Department of Primary Industries

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2 November 2012

John Pierce
Chair
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Our Ref: GI/03/0086

Dear Mr Pierce,

Draft Determination: Economic Regulation of Network Service Providers

Thank you for the opportunity to comment on the Australian Energy Market Commission's Draft Determination regarding the economic regulation of network service providers. I apologise for the delay in submitting on this process. The Department of Primary Industries supports improvements to the current regulatory framework to provide more effective incentives on networks to deliver services efficiently, and appropriate tools and discretion to the Australian Energy Regulator in setting prices and revenues.

Please find attached a submission which addresses both the draft determination and the consultation paper on transitional arrangements.

If you have any questions please contact Raif Sarcich, A/Director Retail Energy Development on (03) 9658 4160 or at raif.sarcich@dpi.vic.gov.au.

Yours sincerely

Mark Feather
Executive Director



SUBMISSION TO THE AEMC'S DRAFT RULE DETERMINATIONS (ERC0134/ERC0135/GRC011)

National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012

National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012

The Victorian Department of Primary Industries (DPI) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (the Commission's) Draft Determinations on the rule change requests received from:

- the Australian Energy Regulator (AER) in relation to the economic regulation of network services
- the Energy Users Rule Change Committee in relation to the methodology for the calculation of the return on debt component.

DPI generally supports the Commission's draft determinations on the rule changes. In this submission, we have provided comment on:

- the capital expenditure (capex) and operating expenditure (opex) allowances
- capex incentives
- timing of the regulatory determination process
- proposed transitional arrangements.

Capex and opex allowances

DPI is generally supportive of the rule changes proposed. However, as indicated in the Victorian Minister for Energy and Resources' submission to the Commission's Consultation Paper and DPI's submission to the Directions Paper, to the extent that there is legal uncertainty regarding the extent of the AER's discretion in the rule changes proposed, it is preferable that they be drafted to put the matter beyond doubt and to reduce the potential for future legal challenge before the Australian Competition Tribunal.

The AEMC seeks in its draft determination to introduce greater use of benchmarking into the regulatory regime, which it considers has been under-utilised in the past.

Importantly, benchmarking relies on gathering data from the Network Service Providers (NSPs). The Commission believes that a change to the National Electricity Law may be required for the AER to do so, but it does not have the power to make such a change. DPI has sought advice on this point and considers that the AEMC is amply able to make rules that provide for the gathering of data, and is willing to share this advice if requested. The AEMC also identifies that changes to the rules may also provide the AER with greater powers in this respect.¹

The gathering of appropriate data is clearly of key concern to support benchmarking. Without systematic and comparable data from all NSPs, the AER will not be able to draw inferences about an

¹ Australian Energy Market Commission, *Draft Rule Determinations: Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 23 August 2012, page 110

individual NSP's performance against a benchmark with sufficient rigor to support its use as an analytical tool informing decisions in pricing reviews. The mere fact of publication of a benchmarking report may not materially improve the AER's pricing determinations.

The AEMC has already undertaken a review into the use of a Total Factor Productivity (TFP) approach to determining the required revenue, which relies on data in a similar way to benchmarking. The Commission was of the view that a sufficiently robust and consistent data-set did not exist to support TFP.

Therefore, the Commission proposed possible rule changes to the Standing Council on Energy and Resources (SCER) which would require NSPs to provide benchmarking information to the AER. No decision has been made by SCER on these possible rule changes in the intervening two years, whilst the AEMC declined to make rules in response to the TFP rule change proposal lodged by Victoria in 2008.

Given that the generation of a comprehensive data set to assess performance by NSPs is an imperative, in the context of this rule determination, in much the same way as it was in the TFP Review, the AEMC should make substantially similar rules to support the AER's role in assessing efficient network expenditure. If there are deficiencies in the NEL with respect to the AER's data gathering powers, this will be more evident and easily resolved if there are not also deficiencies in the NER.

Capex incentives

The Commission has not made any specific rule changes in relation to rolling the margin on related party contracts into the Regulatory Asset Base (RAB). However, the Commission has made a draft rule change that allows the AER to undertake an ex post review of capital expenditure and to reduce the capital expenditure that would otherwise be rolled into the RAB. The Commission is of the view that this rule can deal with inefficient related party margins.

The Commission also states that:

It is up to the AER to determine whether arrangements that were entered into by the NSP and a third party reflect arm's length terms. Similarly, it is up to the AER to determine what the margin would have been if it considers the arrangements do not reflect arm's length terms. However, the AER is required to set out its proposed approach in the capex incentive guideline.²

The approach set out in the capex incentive guideline is thus critical to ensuring that the national economic regulatory regime is better placed than the current regime and the previous state-based regulatory regimes in addressing the issue of related party margins in the RAB.

As a minimum, DPI expects that the capex incentive guideline should include:

² Australian Energy Market Commission, *Draft Rule Determinations: Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, Draft National Gas Amendment (Price and Revenue Regulation of Gas Services Rule 2012*, 23 August 2012, page 151

- the approach that has been adopted by the AER in revenue determinations to assess the related party margins in forecast expenditure
- the use of the enhanced information gathering powers that were provided to the AER to ensure that it was better placed than the Essential Services Commission to gather the information necessary to make adjustments for related party margins.

As stated in the second reading speech for the National Electricity (South Australia) (National Electricity Law – Miscellaneous Amendments) Amendment Bill:

The Bill introduces substantial amendments to the Australian Energy Regulator’s information gathering powers under the National Electricity Law, designed to address ongoing issues of information asymmetry between regulated businesses and the regulator recognised by the Expert Panel.

The amendments enable the Australian Energy Regulator to obtain adequate information from industry to set efficient prices for energy services without placing an unnecessarily heavy administrative burden on industry whilst supporting competition in the energy market place and protecting commercially sensitive information.

Information on costs incurred in supplying network services is a critical input into the regulatory process and is an essential starting point for determining regulated prices for services supplied in such a market.

...

A key component of these reforms is to extend the Australian Energy Regulator’s information gathering powers to parties related to the service provider. This mechanism is designed to ensure that the Australian Energy Regulator has sufficient information to perform its functions and to discourage service providers from using corporate structures to avoid disclosure of information to the regulator ...

If the AER exercises these enhanced information gathering powers as intended, the AER can ensure that customers only pay for the costs associated with providing distribution services, which is in the long term interests of customers.

Timing of the regulatory determination process

DPI supports the Commission’s draft rule requiring the AER to publish an issues paper. However, it is concerned with the Commission’s proposal to extend the regulatory determination process by 120 business days.

DPI does not agree that the benefit of commencing the regulatory determination process earlier by six months outweighs the risk of less accurate and available information for forecasts. DPI also queries how the environment for economic regulation of network services has changed to justify a six month extension.

As indicated in DPI’s submission to the Directions Paper, the Essential Services Commission (ESC) made the revenue determination for the five Victorian electricity distribution businesses for 2006-10 within 12 months, seven months less than proposed by the Commission for the AER. During this

twelve month period, the ESC published two additional papers (a Summary Paper and a Position Paper) and also responded to an appeal lodged between the Draft Determination and the Final Determination.

A comparison between the ESC’s process, the AER’s current process and the Commission’s proposed process is illustrated in the table below.

Key milestone	ESC’s process	AER’s current process	Proposed process
Framework and Approach – Consultation paper	March 2004	December 2008	August 20xx
Final Framework and Approach	June 2004	May 2009	December 20xx
Regulatory Proposals	October 2004	November 2009	June 20xy
Summary Paper	November 2004		
Issues Paper	December 2004		August 20xy
Position Paper	March 2005		
Draft Decision	June 2005	June 2010	April 20xz
Final Determination	October 2005	October 2010	October 20xz

Note: ESC’s Final Determination delayed due to an appeal lodged by United Energy following the release of the Draft Decision

If the regulatory determination process is extended as proposed, consumer representatives, NSPs, the AER and other stakeholders will need to resource their project teams for a longer period of time, which will considerably increase the costs associated with the regulatory determination process.

DPI is of the view that the regulatory determination process could be *shortened*, in line with the timeframe adopted by the previous state-based regulators, if changes were made to the AER’s governance, processes and systems, or if there was an increase in the capability and capacity of AER’s resources. DPI notes that the SCER initiated discussions on these matters at its special meeting on 5 October 2012³. While the AEMC cannot ultimately determine these matters, it should take into account the professed intent of the SCER to ensure that the AER has sufficient capacity to perform its roles. The rules the AEMC makes should be developed according to its expectations of what a well-resourced and competent regulator can achieve, and should detail what these expectations are.

Transitional arrangements

On 14 September 2012, the Commission released a consultation paper on the transitional arrangements to transition a number of service providers to the new rules proposed in the draft rule determination.

If the Commission’s approach is adopted, DPI supports retaining a number of provisions from the current regulatory period for the transitional determination.

However, DPI has a number of concerns in relation to the transitional arrangements. In particular, DPI is concerned that:

³ See SCER Communiqué at <https://scer.govspace.gov.au/files/2012/10/Final-SCER-Communiqu%C3%A9-Energy-Ministers-5-Oct-121.pdf>

- the Commission has underestimated the effort that would be required to prepare a regulatory proposal for a one year period and for the AER to assess that regulatory proposal, particularly the rate of return and especially if the decision is appealed
- stakeholders will have little opportunity to engage in the process given the timeframes and absence of an Issues Paper
- the NSPs will not have the appropriate incentives during that one year period, particularly as no incentive schemes will apply in that year; the Service Target Performance Incentive Scheme provides the incentive for NSPs to deliver the preferred level of service to Victorians and should be rolled forward for an additional year to prevent gaming of the one year gap by networks. Similarly, the Efficiency Benefits Sharing Scheme could also be rolled forward for an additional year.
- metering expenditure will need to be considered as part of the Victorian electricity NSPs revenue determination for 2016.

If this approach is adopted, DPI notes that the one year determination could be simplified for the Victorian electricity DNSPs by rolling forward the approach to determining the opex. The only expenditure that would need to be explicitly considered by the AER is any step changes.

Alternatively, the Commission could consider applying a TFP-based price path for the one year or freezing network charges in real terms for one year with a Service Target Performance Incentive Scheme. These approaches would be far less resource-intensive and less costly.