



Australian Energy Market Commission

CONSULTATION PAPER

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

Rule Proponent(s)

SP AusNet
ElectraNet

22 March 2012

**RULE
CHANGE**

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. The AEMC has two principal functions. We make and amend the national electricity and gas rules, and we conduct independent reviews of the energy markets for the MCE.

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1 Introduction

On 18 November 2011, SP AusNet submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission) relating to the value of the assumed utilisation of imputation credits applying to transmission network service providers (TNSPs) under Chapter 6A of the National Electricity Rules (NER). Similarly, on 30 November 2011, ElectraNet submitted a rule change to the AEMC on the same matter.

These rule change requests have been consolidated and are being treated as one rule change request.

This Consultation Paper has been prepared by the staff of the AEMC to facilitate public consultation on this consolidated rule request and does not represent the views of the AEMC of any individual Commissioner of the AEMC.

This paper:

- sets out the process undertaken to consolidate the two rule change requests;
- sets out a summary of, and a background to, assumed utilisation of imputation credits proposed by SP AusNet and ElectraNet;
- identifies a number of questions and issues to facilitate consultation on the consolidated rule change request; and
- outlines the process for making submissions.

2 Consolidation of the rule change requests

The AEMC has determined that the SP AusNet and ElectraNet rule change requests meet the statutory criteria set out in section 94 of the National Electricity Law (NEL) and therefore is initiating the rule change process for them.

Having regard to the fact that the two rule change requests have identified a similar problem in the NER and were received at a similar time, the AEMC has decided to consolidate these rule change requests and treat them as one request for the purposes of the making of a rule by the AEMC under Part 7 of NEL.

Through consolidation, the AEMC will be able to consider the issues raised by both rule change requests together and make an informed decision as how best to address the problem identified. Additionally, consolidation will make it easier for stakeholders to engage in the rule change process. By consolidating, stakeholders will not be required to provide submissions twice on what is, essentially, one matter.

3 Details of the consolidated rule request

3.1 Background

3.1.1 Gamma

The rule change requests concern the value of gamma (γ) that is applied to the coming revenue determinations for SP AusNet and ElectraNet.

In chapter 6A of the NER, the weighted average cost of capital (WACC) is an estimate of the fair return on capital that investors (being debt holders and equity holders) in the benchmark firm might reasonably expect as compensation for having their capital at risk.

Under chapter 6A the AER must conduct a review of the WACC parameters every 5 years. For some parameters, the specific values adopted in the review cannot be departed from in determinations over the subsequent 5 year period. These parameters include equity beta, market risk premium, gearing, credit rating, and gamma; the last of which is the subject of this rule change request. The last review was carried out in 2009 and the next one is scheduled for 2014.

The estimated cost of corporate income tax is usually considered in conjunction with WACC parameters. It is important because the investors' return on capital must be after corporate tax. For this reason, the estimated cost of corporate income tax is added to a TNSP's revenue requirements.

Gamma is relevant to the estimated cost of corporate income tax. It represents the value of imputation credits and has an effect on the "grossing up" of a TNSP's revenue requirements for corporate income tax.

Dividends paid to shareholders by Australian resident companies are taxed under a system known as imputation. The tax the company pays is imputed, or attributed to the shareholders. The tax paid by the company is allocated to shareholders by franking or imputation credits attached to dividends they receive. These credits can be used by shareholders to offset any tax payable on other taxable income received.¹

Where the value of imputation credits or gamma is higher, the estimate of corporate income tax that is added to a TNSP's revenue requirement will be lower because individual investors can offset their individual tax liability by the imputation credits. Where the value of imputation credits is lower, the estimate of corporate income tax that is added to a TNSP's revenue requirement will be higher as investors will require a higher return to cover their tax liability from income earned from their investment in that TNSP.

¹ For further information, see the Australian Taxation Office homepage at www.ato.gov.au

In summary, the value of gamma has the following impact on the building block revenue and prices:

- a decrease in gamma increases the building block revenue and prices; and
- an increase in gamma decreases the building block revenue and prices.

3.1.2 Merits review

The value of gamma has been subject to merits review by electricity distribution network service providers (DNSPs). As a result of merits review in the electricity distribution context, the Australian Competition Tribunal (Tribunal) has determined that the correct value of gamma for electricity distribution network service providers is 0.25, as opposed to 0.65, which was also the AER determined value in its 2009 WACC review for TNSPs.

Since the merits review of the gamma the AER has adopted the revised value of 0.25 in electricity distribution (and gas). The NER do not, however, permit the AER to consider applying the revised gamma to any TNSP revenue determination until the next scheduled review of rate of return parameters (scheduled for 2014). Clause 6A.6.4(f) provides:

“If, as a consequence of a review, the AER decides to adopt a revised value or methodology, it must use that revised value or methodology, but only for the purposes of a Revenue Proposal that is submitted to the AER under clause 6A.10.1(a) after completion of the first review or after completion of the five yearly reviews (as the case may be).”

This means that even if the AER considers that the gamma value determined by the Tribunal in the context of DNSPs is the correct value that should be applied for all network service providers, the AER must continue to apply the gamma value that it fixed in its 2009 review for electricity transmission.

3.2 Rule change requests from SP AusNet and ElectraNet

3.2.1 Overview of the rule change requests

The rule change requests received from SP AusNet and ElectraNet seek to amend clause 6A.6.4 of the NER regarding the value of gamma, so that the revised gamma of 0.25 applies to their next revenue determinations.

3.2.2 Proponent's rationale for the rule change request

A number of points in support of the rule change requests are summarised as follows.

- SP AusNet's rationale:

- The rules for TNSPs differ from those that apply to electricity distributors and gas networks, where the gamma is not ‘locked in’. It is anomalous that the current NER require a known error in relation to gamma to be perpetuated in future transmission revenue determinations until March 2014. The anomaly is exacerbated because it is confined to TNSPs while determinations for other energy networks will be able to adopt the correct gamma value.²
- The Rule change proposal does not apply retrospectively. It will only apply to future transmission revenue determinations, where the revenue proposal is submitted prior to the completion of the AER’s next five yearly review of the WACC and tax parameters, which is scheduled for 31 March 2014.³
- The Rule change proposal does not undermine or pre-judge the outcome from the AER’s scheduled review of the WACC and tax parameters. Instead, the Rule change only has the effect of correcting errors in the AER’s 2009 SORI, in accordance with the Tribunal’s findings.⁴
- ElectraNet's rationale:
 - This amendment is required to deal with the unique circumstances in which TNSPs now find themselves, where future transmission determinations would otherwise be subject to a gamma value that is known to be erroneous and which the AER has conceded was in error.⁵ That is, any revision of gamma in the AERs next review of the WACC parameters will only apply to revenue proposals submitted after the completion of that review. This means that in the absence of any rule change, a value for gamma of 0.65 must apply to transmission determinations for South Australia (ElectraNet - 1 July 2013 to 30 June 2018), Victoria (SP AusNet - 1 April 2014 to 31 March 2019), and possibly NSW (Transgrid - 1 July 2014 to 30 June 2019) and Tasmania (Transend - 1 July 2014 to 30 June 2019).⁶
 - A gamma of 0.65 if applied is inconsistent with the Revenue and Pricing Principles in the NEL which state that a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services. Continuing to apply a value for gamma that is demonstrably too high will lead to an understatement of the cost of corporate income tax in TNSPs revenue allowances and will therefore prevent recovery of efficient costs.⁷

2 SP AusNet rule change request, 18 November 2011, Attachment 2, p.1.

3 Ibid.

4 Ibid. p.2.

5 ElectraNet rule change request, 30 November 2011, p.6.

6 Ibid.

7 Ibid. p.5.

3.3 Proposed amendments to the rules

Both rule change requests include proposed rules. However, to facilitate SP AusNet and ElectraNet to be able to use the Tribunal determined value of gamma in their forthcoming revenue proposals, the rule change requests propose two separate solutions:

- SP AusNet has proposed an amendment to clause 6A.6.4(f) and the addition of a new clause 6A.6.4(g) that provides, “if the Australia Competition Tribunal determines that the AER’s most recent review of the matters referred to in clause 6A.6.4(d) resulted in an error or errors, and as a consequence of that determination, a different methodology or value is ascribed to the assumed utilisation of imputation credits, the AER must use that different methodology or value for the purposes of clause 6A.6.4(f)”.⁸
- On the other hand, ElectraNet has proposed that clause 6A.6.4 be updated to deem the value for gamma as it has been determined by the Tribunal, subject to future periodic reviews of WACC parameters. According to ElectraNet, this simple amendment would maintain the original intent of the rules in respect of the determination of tax and WACC parameters for TNSPs, while providing for correction of the value for gamma. In addition, ElectraNet has proposed a one-off transitional rule under Chapter 11 of the rules. This amendment would have the effect of obliging the AER to apply a value for assumed utilisation of imputation credits of 0.25 in determining the estimated cost of corporate income tax referred to in clause 6A.6.4 for the South Australia transmission determination for the regulatory control period commencing 1 July 2013.⁹

⁸ SP AusNet rule change request, 18 November 2011, Attachment 2, p.8.

⁹ ElectraNet rule change request, 30 November 2011, p.10.

4 Assessment framework and issues for consultation

4.1 Proposed rule for assessment

The Commission intends to assess the consolidated rule change request on a transitional basis under chapter 11 of the NER. That is, the Commission will consider whether the revised gamma of 0.25 should be able to be applied to the next revenue determination for SP AusNet and ElectraNet. The Commission does not propose to consider the broader issue of the Tribunal decisions on the value of gamma, as this is effectively being considered in another rule change request.

As stakeholders would be aware, the AEMC is currently assessing a rule change request from the AER on network regulation. The Commission's initial view is that the rate of return framework under Chapter 6A for TNSPs appears to be no longer appropriate. Even though this framework provides stability and certainty by locking in a number of WACC parameter values for five years, this may potentially come at the expense of a decline in the resulting appropriateness of the required rate of return for TNSPs over time.¹⁰

The Commission's initial preference in relation to the rate of return frameworks is for a single framework to be used across electricity distribution, electricity transmission and gas networks. Those frameworks will continue to be based on estimating the WACC for a benchmark efficient firm. In addition, the rate of return framework should not prescribe the methodology or values for parameters, but rather provide guiding principles.¹¹

The broader WACC framework (including when and how gamma should be varied) will be assessed through the AER's network regulation rule change request.

4.2 Assessment framework

The Commission's assessment of this rule change request must consider whether the proposed rule promotes the National Electricity Objective (NEO) as set out under section 7 of the NEL. The NEO is set out as follows:

“The objective of this Law 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 – :

- (a) price, quality, safety, reliability and security of supply of electricity;
and
- (b) the reliability, safety and security of the national electricity system.”

¹⁰ AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Directions Paper*, 2 March 2012, p.92.

¹¹ *Ibid*, p.66.

The assessment of the consolidated rule change request will also include other considerations, such as taking into account the revenue and pricing principles.¹² There are no relevant MCE statements of policy principles relating to this rule change request.

The consolidated rule change request could potentially affect the ability of, and the efficient operation of, the incentives on SP AusNet and ElectraNet to invest in their network assets for their next regulatory control period. Generally, any change in the level of investment in networks is likely to impact the price, quality, reliability and security of supply of electricity. The Commission will assess whether the consolidated rule change request will better balance the need to attract sufficient investment in the networks with the need to ensure that prices for consumers are no more than necessary to provide an appropriate level of service. In assessing this rule change request against the NEO, the factors to consider include:

- recovery of efficient costs – is a revised gamma for distribution network services providers automatically the appropriate gamma value for TNSPS? Would a revised gamma applying to SP AusNet and ElectraNet ensure that they are able to fully recover an efficient level of costs to encourage efficient investment in, and operation of, transmission networks for their next revenue determinations?
- investment incentives – does amending gamma for their next revenue determinations provide SP AusNet and ElectraNet with the required incentives necessary to undertake efficient investment in transmission networks?
- regulatory certainty and transparency – would a rule permitting the gamma to be revised for SP AusNet and ElectraNet’s next revenue determination provide an appropriate amount of regulatory certainty and transparency to reduce ambiguity in the suitable value of gamma to apply? What impacts would this have on the current arrangements for other TNSPs?

Also, it will be necessary to assess whether the rule relating to the gamma value to apply for the estimated cost of corporate income tax for the next revenue determinations for SP AusNet and ElectraNet, compared with the current arrangements, would meet the objectives and principles of the regulatory framework under chapter 6A of the rules, including:

- achieving a balance between the interests of TNSPs and end customers;
- having regard to the appropriate role of AER as economic regulator; and
- providing transparent and timely regulatory processes.

The proposed rule will be assessed against the relevant counterfactual arrangements, which in this case are the current provisions relating to gamma under the rules.

¹² The revenue and pricing principles are set out under section 7A of the NEL.

4.3 Issues for consideration

The issues outlined below are provided for guidance. Stakeholders are encouraged to comment on these issues as well as any other aspect of the rule change request or this paper including the proposed assessment framework.

Taking into consideration the assessment framework and potential requirements to implement the proposed rule change, we have identified a number of issues for consultation that appear to be relevant to this rule change request.

Question 1 Recovery of efficient costs

Would applying the current value of gamma for TNSPs for SP AusNet and ElectraNet's next revenue determinations likely lead to those TNSPs not being able to recover their efficient costs? Please provide reasons.

Question 2 Investment incentives

How would applying the current value of gamma for TNSPs for SP AusNet and ElectraNet's next revenue determinations affect investment incentives for these TNSPs? Please provide reasons.

Question 3 Regulatory certainty

- (a) Would this rule change provide an appropriate amount of regulatory certainty and transparency in reducing ambiguity as to the most suitable value of gamma to apply to SP AusNet and ElectraNet?**
- (b) What impact would this rule change have on the current arrangements for other TNSPs?**

Question 4 Other considerations

What would be the impacts on consumers and other stakeholders of a rule that permitted the SP AusNet and ElectraNet to apply a different gamma value at their next revenue determinations, being the one determined to be most appropriate for distributors?

5 Lodging a submission

The AEMC has published a notice under section 95 of the NEL for this rule change proposal inviting written submission. Submissions are to be lodged online or by mail by 19 April 2012 in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the AEMC's Guidelines for making written submissions on rule change requests.¹³ All submissions will be published subject to a claim of confidentiality.

All enquiries on this project should be addressed to James Eastcott on (02) 8296 7800.

5.1 Lodging a submission electronically

Electronic submissions must be lodged online via the AEMC's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code ["ERC0143"]. The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the AEMC will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

5.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by Fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0143.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the AEMC will issue a confirmation letter.

If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

¹³ This guideline is available on the Commission's website.

Abbreviations

ACT	Australian Competition Tribunal
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Commission	See AEMC
MCE	Ministerial Council of Energy
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National electricity rules, or the rules
SORI	Statement of regulatory intent
TNSP	Transmission network service provider