



Submission to the Australian Energy Market Commission

**Review of Electricity Transmission Revenue
and Pricing Rules**

Response to Draft Rule and Rule Proposal Report

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1. Overview

The Energy Networks Association (ENA) welcomes the opportunity to comment on the *Transmission Revenue: Rule Proposal Report* and the *Draft National Electricity Amendment* (Draft Rule) released by the Australian Energy Market Commission as part of its ongoing Review of Electricity Transmission and Pricing Rules.

The ENA considers this review and Draft Rule to have relevance to gas and electricity distribution businesses due to the aspects of revenue and pricing issues that cover common or similar ground for both transmission and distribution businesses. This submission focuses on particular aspects of the proposed rules of most concern to energy distribution businesses in any future distribution rule development process which took as a starting point the AEMC's current proposals for Chapter 6.

A feature of the Draft Rule is an adoption of a limited form of the 'propose-respond' regulatory model operating in the national gas access regime and the West Australian electricity access regime. Energy network businesses consider that the limitations placed in the Draft Rule on the operation of the propose-respond model (applying the model only to the operating and capital expenditure elements of a total revenue allowance) are inappropriate and not justified by evidence to date from the operation of this model under access regimes to date.

The ENA supports the operation of a broader propose-respond model which, for example, includes the right to propose a weighted average cost of capital for the purpose of establishing the return on capital element of the building block revenue calculation. In the event that the AEMC's draft determination does *not* remove the limitations proposed in the Draft Rule, the ENA has a number of comments on how these provisions might be amended to deliver improved long-term certainty and stability. In addition, energy network businesses present alternatives for the future treatment of cost of capital assessments applying to distribution, which recognise some areas of difference between transmission and distribution.

An additional area of key concern is that draft provisions relating to the AER's considerations in approving 'reasonable estimates' of future capital and operating costs are clear and certain in their application. The risks and deficiencies in providing regulators 'laundry lists' of objectives and factors to take into account are well documented in recent Productivity Commission reviews of the gas and national access regime and the Prime Minister's Infrastructure Taskforce. The ENA supports simplified drafting in this area which focuses on the basic requirement that the estimate be reasonable and does not prescribe so wide a range of detailed conditions or factors to be assessed.

2. Background

This submission responds to the *Transmission Revenue Rule Proposal Report* released by the Australian Energy Market Commission as part of its ongoing Review of Electricity Transmission and Pricing Rules in February 2006.

The Energy Networks Association is the national representative body for gas and electricity distribution network businesses. The members of the ENA include:

- ActewAGL
- AGL Energy Networks
- AlintaGas Networks
- Aurora Energy
- Citipower
- Country Energy
- ENERGEX
- EnergyAustralia
- Envestra
- Ergon Energy
- ETSA Utilities
- Integral Energy
- Multinet Gas
- NT Power and Water Corporation
- Powercor
- SP AusNet
- United Energy Distribution
- Western Power

Energy network businesses deliver electricity and gas to over 12 million customer connections across Australia through approximately 800 000 kilometres of electricity lines and 75 000 kilometres of gas distribution pipelines. These distribution networks are valued at more than \$35 billion, and each year energy network businesses undertake investment of around than \$5 billion in network operation, reinforcement, expansions and greenfields extensions.

3. Context for energy distribution response to Draft Rule

The ENA considers this review to have relevance to gas and electricity distribution businesses due to the aspects of revenue and pricing issues that cover common or similar ground for both transmission and distribution businesses. In its previous Scoping Paper the AEMC recognised that decisions in relation to the future of transmission revenue and pricing regulation have the potential to impact on future approaches in relation to electricity and gas distribution networks.

The AEMC currently has no reference to examine National Electricity Rules relating to the economic regulation of electricity distribution networks. In many areas, however, there are strong arguments for common approaches between electricity transmission and gas and electricity distribution. The ENA has limited its comments to those particular aspects of the proposed Rules that would be of most concern to energy distribution businesses in any future distribution rule development process which took as a starting point the AEMC's current proposals for Chapter 6.

4. Scope and definition of regulation

The Draft Rule proposes the introduction of several significant restrictions on the form of regulation which may be applied in relation to electricity transmission networks.

‘Building blocks’ regulation using a CPI-X approach and taking into account firm-specific costs is the predominant form of regulation currently applying to monopoly infrastructure across Australia. Mandating this approach to continue to apply until a formal change to the National Electricity Rules provides an increased level of certainty over reliance on non-binding regulatory guidelines such as the ACCC Statement of Regulatory Principles. The ENA supports the principle that regulatory enforcement bodies, such as the AER, are not the appropriate body to determine the form of regulation to apply. Instead, it is appropriate for an interaction of clear rules and independent assessments of the potential for competition in relevant markets to determine the form of regulation to apply in particular circumstances.

Due to the particular characteristics of electricity transmission networks and the unmanageable nature of throughput, mandating revenue cap regulation may be appropriate. In contrast, distribution networks may in some cases have a greater capacity to forecast and influence throughput, which can make price cap regulation a more appropriate option for distribution assets.

5. Limited propose-respond model

Energy network businesses support the AEMC’s proposal to move electricity transmission regulation towards a form of the ‘propose-respond’ regulatory model closer to that contained in the National Gas Code. Empirical evidence to date suggests that this model leads to more streamlined regulatory processes which are shorter and less costly than those under current electricity regimes which do not define the role of the regulator and the standard of regulatory decision-making.

Limitation in application of model to operating and capital costs

The Draft Rule adopts, however, a limited form of the ‘propose-respond’ model. Its application is restricted to the assessment, effectively, of capital and operating costs. Under the Draft Rule, the AER is required to approve ‘reasonable estimates’ of these forecast costs.

The Draft Rule does not include additional elements of the propose-respond model currently in the National Gas Code, most importantly, the right of a service provider to propose a rate of return consistent with provisions such as s.8.30-8.31 of the Gas Code. Under the Gas Code if a rate of return meets the requirements of s.8.30-8.31, the regulator is not provided with the opportunity to substitute its own determination of a ‘preferable’ rate of return. This model has been operating under the National Gas Code since 1998, and was highlighted in the Australian Competition Tribunal’s ruling in relation to the *GasNet* matter in 2003.

Since the *GasNet* outcome, the propose-respond model has operated in relation to rate of return issues without ever being the subject of further consideration by an appeal body. Indeed there have been no appeals in relation to any gas distribution Access Arrangements made before or after this ruling, and only a single transmission appeal since (in relation to the Moomba-Sydney Pipeline) which is focused on unrelated issues. In this context it is not sustainable to suggest that adopting a fuller propose-respond approach which includes the core return on capital element of the building

block would create uncertainty or lead to more costly or complex price determination processes. In fact, the opposite is true.

The ENA supports the application of the propose-respond model to capital and operating cost elements and the return on capital element of the building blocks approach. It does not consider the limited application of the AEMC's variant of the propose-respond model - to capital and operating costs alone - as necessary or justified by evidence to date from the operation of such a model under the National Gas Code.

Factors for assessing reasonable estimates

Under the Draft Rule the AER is required to approve capital and operating cost forecasts if they represent 'reasonable estimates'. This assessment is to be made by reference to two similar clauses, 6.2.6 (b) (3) (in respect of capital costs) and 6.2.7 (b) (2) (in respect of operating costs).

The ENA is concerned that the drafting of these clauses will negate many of the benefits of movement towards a streamlined propose-respond approach which includes a presumption of acceptance of a reasonable proposal. The two clauses include a detailed and prescriptive list of factors for the AER to take into account in making a decision on whether an estimate is reasonable. In relation to capital expenditure, the lists of factors which the AER must take into account are multi-layered, with 4 elements (6.2.6 (b) (1)-(4)) and no less than 13 sub-clauses. In many cases the logical relationship between sub-clauses and main clauses do not appear to have a clearly discernible rationale. Clause 6.2.7, covering assessment of operating cost estimates is marginally simpler in structure, but still contains 3 clauses underpinned 10 sub-clauses.

The ENA notes that in many cases sub-clauses reference matters which any regulator should reasonably be expected take into account in assessing any element of a service provider's proposals in respect of future expenditure. In ENA's view these complex and lengthy clauses risk:

- encouraging a narrow, legalistic and prescriptive interpretation of the regulators task in assessing proposed expenditure
- unintentionally excluding other relevant matters or material from consideration by omission
- failing to give any guidance on the weight to be accorded to any particular factor
- failing to give appropriate weight to those factors which provisions of the National Electricity Law have specifically identified as fundamental elements of a sound regulatory decision, such as allowance for the recovery of the efficient costs of complying with any regulatory obligations
- apparently giving undue weight or prominence to elements which do not warrant this (for example, the relationship between 6.2.7 (b) (1) and 6.2.7 (b) (2) (i)-(x))

The risks and deficiencies in providing regulators ‘laundry lists’ of objectives and factors to take into account are well documented in recent Productivity Commission reviews of the gas and national access regimes and the report of the Prime Minister’s Infrastructure Taskforce. The ENA supports simplified drafting in this area which focuses on the basic requirement that the estimate be reasonable and does not prescribe such a range of detailed conditions or factors to be assessed.

6. Rules in relation to cost of capital

The AEMC Draft Rule sets out detailed provisions on particular methodologies and values to be used in determining the appropriate weighted average cost of capital for electricity transmission businesses, and proposes that these rules apply on a transmission industry-wide basis for a period of five years.

Energy network businesses support the provision of greater certainty on cost of capital issues in the Rules for electricity transmission businesses (as reflecting the detailed development work carried out in the AER’s Statement of Regulatory Principles).

As identified in Section 4 of this submission, however, energy network businesses consider that a best practice approach for distribution businesses would feature the full operation of the ‘propose-respond’ regulatory model with respect to all elements of a building block proposal, allowing businesses to propose a cost of capital for the purposes of calculating a return on capital.

In the event that the Commission is tasked in the future with considering approaches in relation to fixing cost of capital parameters for electricity or gas distribution businesses, the ENA suggests a number of amendments to the AEMC’s approach to maximise certainty and overcome some significant remaining deficiencies in the Draft Rule in this area.

First, the draft rules provide limited certainty beyond the first five years. Improving certainty beyond this point should take the form of more specific guidance in relation to the conducting of a review of the cost of capital parameters due in 2011 and subsequently at five yearly intervals. This guidance should be in the form of requirements for the body determining the new parameters and methodologies to give specific weight to:

- estimates of the historical values of cost of capital parameters over time
- the need for stability and consistency in cost of capital parameters and estimates over the medium term in the context of the long-lived nature of investments
- the need for a strong evidentiary basis for adjusting parameter estimates given the statistical uncertainty involved in their estimation

This approach is consistent with approaches to regulatory guidance adopted in the existing Electricity Rules (e.g. clause 6.10.3 (e) (6)). Without this approach the ENA considers the Rule provides positive certainty to 2011, but little guidance to ensure that cost of capital estimation decisions and methodologies beyond this date will be

appropriate and take into account the long-lived nature of sunk energy network infrastructure investment.

Second, the ENA considers there may be a case for industry wide assessments of applicable cost of capital parameters and estimates to be undertaken by a body other than the AER. An appropriate body to carry out this function on a sector wide basis may be an expert panel convened under the AEMC for this limited and specific purpose.

Key principles in any future approaches to determining cost of capital estimates from the perspective of energy network businesses are:

- it is appropriate for industry-wide parameters to be determined for fixed length periods that reflect the long-lived nature of investments
- financial/economic experts should have primary involvement in redetermining appropriate parameters and methodologies
- any body tasked with redetermining the parameters and methodologies should have sufficient guidance to carry out its task
- as a key regulatory decision it should be subject to merits review

Another alternative approach which may be considered appropriate if the outcomes of the AEMC's approach was sought to be applied in the future to distribution regulation may be to fix cost of capital parameters in binding AER guideline documents, rather than the rules themselves. This approach is consistent with the fuller operation of the propose-respond model as energy distribution businesses would retain the flexibility to propose cost of capital parameters and methodologies outside of the AER's guideline, to account for potentially different risk and business profiles.

Under this approach, certainty would be provided by the AER being bound to approve such cost of capital parameters as it had determined through a binding guideline were appropriate on an industry-wide basis, but some flexibility would also be retained. This flexibility would recognise the different price and mixed revenue caps arrangements likely to be in place for some time in the energy distribution sector, as well as the potentially different risk profile of some gas distribution networks in specific market circumstances. These issues do not arise in relation to electricity transmission revenue regulation due to their current market and regulatory circumstances, and this supports a potentially differentiated approach.

7. Approach to treatment of past capital expenditure

Energy network businesses support movement to an *ex ante* approach to the treatment of past capital expenditure. *Ex ante* approaches contain strong incentive properties, leading to greater ongoing potential for efficiency and productivity gains by regulated firms. These approaches also reduce regulatory risk inherent in *ex post* reviews of capital expenditure decisions, by avoiding the risk that expenditure which was prudent on a forward-looking basis at the time of investment will be subsequently subject to

regulatory ‘stranding’. *Ex post* reviews also have the potential to be costly and intrusive, without these disadvantages being sufficiently counterbalanced by the risks such reviews are designed to mitigate.

Where Chapter 6 rules move towards an *ex ante* approach, ENA members consider that provision for ongoing *ex post* reviews (outside of cost pass through and re-opener arrangements) is redundant. Providing for both *ex ante* and *ex post* review instead creates high regulatory risk, for little apparent purpose. Energy distribution businesses understand from public consultation forums held to date that both the Australian Energy Regulator and transmission network owners also support the removal of scope for *ex post* reviews.

The Energy Networks Association
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