

7 April 2006

Dr John Tamblyn
Chairman
Australian Energy Market Commission
By email to submissions@aemc.gov.au

Dear Dr Tamblyn

Thank you for the opportunity to make a late contribution to the Australian Energy Market Commission's (AEMC) *Proposed National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006* (the draft Rules).

The Consumer Utilities Advocacy Centre Ltd (CUAC) is an independent advocacy organisation, established to represent the interests of Victorian consumers, particularly low-income, disadvantaged, rural and regional and Indigenous consumers, in policy and regulatory decisions on electricity, gas and water. This submission has been made with the interests of those consumers firmly in mind.

The views expressed in this submission are supported by the Consumer Law Centre Victoria, St Vincent de Paul Society Victoria and the Victorian Council of Social Service.

Electricity is an essential service – it underpins every form of economic and social activity in the State. As such, Victorian consumers expect a range of outcomes from economic regulation of transmission network service providers (TNSPs): continued access to reliable and affordable electricity; efficient market structures; transparent and accountable decision-making; and, as is implicit within the National Electricity Market objective, that the public interest remains the prime imperative for change.

This review is of particular interest to consumers, as it is the first major Rule change undertaken by the AEMC since its establishment, and so – rightly or wrongly – provides an indication as to the AEMC's approach to economic regulation of network assets and pricing. This process has been somewhat complicated by the recent release of the Expert Panel *Draft Report on the Review of Revenue and Network Pricing across the Energy Market* (the Panel Report), and consequential uncertainty about the way forward in energy market reform.

We do not have the capacity to address all the issues discussed in the draft Rule proposal, and so have concentrated on the issues of most concern and moment to consumers. This

submission will therefore comment on the following: the regulatory approach taken by the propose-respond model and the concept of a ‘reasonable estimate’; the codification of key parameters of the weighted average cost of capital (WACC) and, particularly, the debt rating; information requirements; and reopener provisions.

A. Propose-respond model

In principle, we welcome the AEMC’s decision to fix a timeframe and clear consultation process for regulatory decision-making. A clear understanding of the timelines for consultation before the process begins is of particular assistance to consumer groups who often need time to amass the resources and information required to make a substantive contribution. Related to that, we would strongly encourage the AEMC to consider how it can best consult with consumer organisations and, particularly, how it supplies information to those stakeholders and the timelines it allows.

As stated earlier, consumers expect that economic regulation will produce reliable and affordable supply, and that decision-making will be transparent. Related to these expectations, we have two key concerns relating to the propose-respond model outlined in the draft Rules: the first relates to the potential for such a model to direct regulatory returns toward industry at the expense of consumers; the second, that there may be increased scope for gaming by industry.

CUAC notes the comments of the Expert Panel in its Report that “a propose-respond model (particularly in the form proposed by the Productivity Commission) would lead to a systematic increase in the returns to regulated entities relative to the consider-decide model”¹. The Panel identifies a ‘systematic upward bias’ in such an approach and questions whether this approach is the best means of dealing with the perceived flaws of the current regulatory regime (particularly truncated returns and asymmetric risk from regulatory error). The Panel also states that the risk is greatest when dealing with greenfields investment – that the potential for, and consequences of, regulatory error in relation to mature networks is much less pronounced².

These comments are particularly relevant in light of the recent release of the Australian Energy Regulator’s (AER) first electricity regulatory report, which identified that the current regulatory model has enabled relatively high levels of capital expenditure, with over \$1.6 billion invested in the assets over the last three years³. Such a result does not seem to support the view that further incentives must be embedded into the regulatory framework in order to encourage investment.

We would therefore appreciate that the AEMC explicitly address these concerns in its final Rules – while transmission may comprise a smaller proportion of a consumer’s bill, for those

¹ Expert Panel *Draft Report on the Review of Revenue and Network Pricing across the Energy Market*, March 2006, p 68

² *Ibid*, p. 69

³ AER *Transmission Network Service Providers Electricity Regulatory Report 2004/05*, April 2006

consumers for whom every dollar counts, we would be remiss to accept any approach that provides industry with an unwarranted advantage and one that will be paid for by consumers.

We also note the comments of the Panel in relation to the concept of ‘reasonable estimate’ and, particularly, as providing too little guidance for the regulator. Indeed the Panel goes further to state “that the effect of requiring a regulator to consider whether a proposal is within a reasonable or plausible range is to require the regulator to apply a less well understood decision making criterion than would be the case if the regulator was required to form a view upon the most appropriate (or best) outcome its judgement”⁴. The Panel also identifies that the likely outcomes of wholesale adoption of the Productivity Commission recommendations are greater regulatory uncertainty, increased litigation, and an upward bias to the returns provided for TNSPs⁵.

We also strongly support the criticisms made by the Panel and the AER⁶ in relation to the potential incentive such an approach provides to gaming by industry, when coupled with the presumption of approval by the AER of a TNSP’s proposal. The Panel makes the point that the regulated business in fact is given an incentive to make an ambit claim to identify the regulator’s estimate of a reasonable range.

The notion of a ‘reasonable estimate’ seems to pose more questions than it answers and we would strongly encourage the AEMC to revisit its support for the concept, and pursue a methodology that provides more guidance to the regulator and does not provide any incentive for gaming by businesses.

B. Return on capital

1. Codification of WACC Parameters

A significant change to the regulatory framework proposed in the draft Rules has been the codification of parameters within the WACC. While we have limited ability to comment on the values of the parameters specified in the draft Rules, we have noted with some concern the response from regulatory agencies (the AER and the WA Economic Regulatory Authority (ERA)) that the degree of codification recommended by the AEMC in its draft Rule will reduce the discretion and flexibility of the regulator.

The ERA notes that the values tend to be or are at the upper bounds of recent regulatory decisions relating to the cost of capital, and questions whether the values therefore perhaps favour TNSPs⁷ – if that were indeed the case, we would be strongly concerned given the findings of the AER’s recent TNSP performance report would seem to indicate little evidence for such incentives to be put in place given the main emerging trends.

⁴ Expert Panel Draft Report, p 75

⁵ Ibid p 81

⁶ AER Submission to the AEMC Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006 March 2006

⁷ ERA Submission to the AEMC - Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006, 20 March 2006, p 5

That report identified that: aggregate actual spending is significant at more than \$1.6 billion over the past three years, although lower than forecast in the revenue caps; the aggregate value of the TNSPs' regulated assets has increased by almost 12 per cent over the past three years and now stands at almost \$10.3 billion; TNSPs have been spending close to forecast levels with aggregate spending over the past three years approaching \$1 billion; and most TNSPs continue to exceed the reliability standards specified in their revenue caps, with incentive payments totalling almost \$4.5 million for the 2004 calendar year.⁸

We would therefore endorse the proposal put forward by the AER, that the AEMC require the AER develop binding guidelines on the WACC parameters. Such an approach would seem to neatly marry the need for certainty with the ability to provide the regulator with the discretion it requires to adapt to changing circumstance.

The draft Rule also notes that "... there are limitations in the availability of market evidence which would support change to the value of a number of the parameters used in the CAPM model. In these circumstances review of these WACC parameters in each regulatory determination process has little benefit and simply contributes to uncertainty about the return on past investments"⁹. We are perplexed by the 'limitations in the availability of market evidence' as this is not clearly expounded.

Further, while the underlying parameters of WACC are arguably fixed and provide for long-term stability and investor certainty, we do not consider a review to the WACC parameters as contributing to uncertainty about return on past investments. Discussion about these parameters is worthwhile for the purpose of ensuring they are methodologically sound and reflect market dynamics and realities.

We recognize that prescribing WACC inputs reduces the flexibility of the regulator, such as its ability to respond to new information or to undertake a benchmarking exercise of the WACC. It would therefore be worthwhile for the Draft Rule to clearly articulate the actual length of time 'in the medium to longer term' in terms of reviewing return on capital.

The draft Rule proposes that the value of key components of the WACC should be subject to a five-yearly review. We recommend an interim review should be undertaken in the third year given the likelihood of short term and mild cyclic fluctuations in business conditions, interest rates and economic activity that will affect these indicators. This will serve as a means of monitoring and verification of the set values.

2. Debt Risk Premium and Debt Rating

We have serious concerns relating to the BBB investment grade rating. We believe that the BBB investment grade rating is erroneous and inappropriate – it is the lowest end of investment grading and is, therefore, attributed the highest risk rating. We acknowledge that State regulators set ratings below their central estimate in the interest of being conservative, choosing to ensure that there is no deterrent to investment at the expense of higher prices for

⁸ AER *Transmission Network Service Providers Electricity Regulatory Report 2004/05*, April 2006, p ii

⁹ AEMC Draft Rule Proposal, p 63

consumers. But, as Lally makes clear, conservatism at the level of each parameter results in an overly conservative output price.¹⁰

In light of its consideration of recent regulatory decisions in relation to the debt risk premium, the credit ratings of a range of energy network businesses and their diverse ownership and credit ratings applicable to infrastructure asset investments, we do not support the AEMC view that an appropriate credit rating for a benchmark electricity transmission business within the investment grade range is BBB.

Research undertaken by Lally¹¹ supports the view that a BBB rating for transmission businesses is inappropriate. Lally notes that, by using the averaging technique, the Standard and Poor's (S&P) ratings for all four of the wholly privately owned distribution businesses yield an estimate for such businesses of 6.5, which implies a rating on the boundary of A-/BBB+. The average leverage of these four firms is very close to 60% and therefore no correction is required for leverage. However, since theory and the comments of S&P both point to a better rating for transmission than for distribution, then the appropriate rating for a privately owned transmission business at leverage of 60% would be at least A-.

A study of S&P credit ratings reveals the median credit rating for public and private electricity transmission and distribution companies is between A- and A+¹². Only ElectraNet and United Energy exhibit credit ratings of less than A-, and in both cases the lower credit ratings are associated with high gearing. CUAC supports the AER's finding that the appropriate benchmark credit rating in calculating a TNSP's debt margin is 'A'.¹³

We therefore strongly recommend that the AEMC revise its decision and set the appropriate credit rating at a level that more accurately reflects the sector.

C. Information requirements

As the Expert Panel states: "provisions that ensure that, within reasonable bounds of cost and commercial confidentiality, the regulator and stakeholders are well informed about the ongoing input costs of regulated services are fundamental to addressing information asymmetry" (p 74).

There are two aspects of the information requirements about which we have concerns within the draft Rule proposal.

First is the provision of information by the TNSP to the regulator and, particularly, the proposition within the Rules that each TNSP will determine its methodology for forecasting operating and capital expenditure. Our experience in other regulatory processes is that such an approach only adds to what is already a complex collection of datasets, and greatly restricts

¹⁰ Lally, M. The Appropriate Credit Rating for Australian Electricity Transmission Businesses, Victoria University of Wellington, March 2006, p 7.

¹¹ Lally, M., *op cit* p.13.

¹² AER Submission to the AEMC Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006 March 2006, p 26

¹³ *ibid*

the ability of stakeholders and, particularly, consumers, to provide comment in detail on those forecasts by vastly increasing the resource burden required to participate to analyse these different methodologies to assess the impacts on consumers or classes of consumers. And without substantive contributions from stakeholders, there is a very real risk of reducing the transparency of the process. We would also be concerned that enabling TNSPs to develop their own methodology reduces the value of 'competition by comparison', which should be a powerful driver in improving service.

The second relates to the publication of information by the AER. We strongly support the AER's comments that the draft Rules should be amended to ensure the AER is able to publish its annual report containing information on each TNSP's network characteristics, including financial indicators, operating ratios, service standards performance, and comparisons between actual outcomes and revenue cap components. Such a report should rightly be viewed as an important plank in the accountability arrangements of the TNSP and the regulator, and has made a valuable contribution to public knowledge of the key issues in the network.

D. Revenue reopeners

While we acknowledge there may be a need to reopen the revenue cap to incorporate unforeseen capital expenditure, we are concerned that such a provision must incorporate strong incentives for TNSPs to provide robust and rigorous capital expenditure forecasts. Any capex over- or under-spend must be able to be identified and assessed by the regulator in making its determinations for the following regulatory period.

We also note the concerns raised by the AER in its submission to the draft Rules that the proposed ex-post review mechanism would not provide it sufficient authority to review the efficiency of the TNSP proposal.

We would therefore encourage the AEMC to review the revenue reopener provisions in the draft Rules, to ensure they in reality provide the correct incentives for business to undertake robust capex forecasts at the beginning of a regulatory period.

Any questions about this submission can be addressed to Kerry Connors at (03) 9639 7600.

Yours sincerely

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