Submission to the Australian Energy Market Commission

Review of Electricity Transmission Revenue and Pricing Rules

Response to Revenue Requirements Issues Paper

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1. Overview

The Energy Networks Association (ENA) welcomes the opportunity to comment on the *Revenue Requirements Issues Paper* (*Issues Paper*) released by the Australian Energy Market Commission as part of its ongoing Review of Electricity Transmission and Pricing Rules.

The ENA recognises that the review of Chapter 6 is appropriately focused on potential amendments relating to the regulatory framework applying to electricity transmission businesses. AEMC and governments, however, have signalled that outcomes of Chapter 6 review may inform future policy developments in energy distribution regulation.

In this context the ENA considers this review should take into account a range of broad policy developments and developments in regulatory practices since the drafting of the initial National Electricity Code. In particular, the ENA considers that the development of national infrastructure pricing principles (in Part IIIA of the *Trade Practices Act*) and several critical reviews of infrastructure regulation have key implications for the AEMC's rule making in relation to this review.

Providing for a flexible scope for regulation to recognise emerging competition and contestability should be an integral element of any energy access framework. In this regard providing scope for the introduction of lighter handed forms of regulation including price monitoring is supported, even if scope for its application to core transmission services appears limited at this point. Price monitoring can be an appropriate form of regulation for a range of greenfields or contestable distribution services.

Energy network businesses support an *ex ante* approach to capital expenditure, with appropriate mechanisms to recognise where changes in demand or other unanticipated circumstances may lead to a need to review the adequacy of forward capital expenditure assumptions. Similarly, ENA members support the rolling forward of regulatory asset values in a transparent and predictable process, and improved guidance on the treatment of operating costs in regulatory decisions.

An appropriate regulatory framework should also provide greater guidance on establishing benchmark regulatory rates of return, with this guidance recognising the uncertainties associated with cost of capital estimation, and the asymmetrical impacts of error in relation to this core building block component. The ENA supports the regulatory framework acknowledging the existence of a range of reasonable cost of capital estimates, as part of the ENA's commitment to a framework which defines the scope of the regulators discretion to reject or amend proposed terms and conditions of access proposed by a service provider.

The ENA notes that the 'propose-respond' model is one recommended by the recent Prime Minister's Export Infrastructure Taskforce, and implemented by the recently finalised WA Electricity Network Access Code. Critically, this model has been in operation for 8 years under the existing National Gas Code. Energy network businesses consider this to be a sound, balanced regulatory model which has operated sustainably over time under a nationally consistent regime.

2. Background

This submission responds to the *Revenue Requirements Issues Paper* released by the Australian Energy Market Commission as part of its ongoing Review of Electricity Transmission and Pricing Rules in October 2005.

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 ENA participation within the review

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 ENA notes that the AEMC currently has no reference to examine National Electricity Rules relating to the economic regulation of electricity distribution networks. The MCE on 4 November 2005 announced the establishment of an expert review panel to consider issues of generic energy access pricing rules to apply to energy distribution and transmission networks. The ENA considers this expert review panel provides a more appropriate forum than the AEMC review through which generic issues relating to the nature of regulation to apply to energy distribution assets should be considered. Given the parallel operation of the Chapter 6 review, however, and continuing uncertainty regarding how the outcomes of the Chapter 6 review and the expert panel review will be integrated, the ENA considers that it must participate fully in the AEMC's current review.

Policy context of the review of Chapter 6 of the National Electricity Rules

This *Issues Paper* has been released subsequently to three significantly relevant inquiries, including the Senate Economics Legislation Committee's *Inquiry into the provisions of the Trade Practices Amendment (National Access Regime) Bill 2005*; the Prime Minister's *Export and Infrastructure Taskforce Report;* and the Productivity Commission's *Review of the Gas Access Regime.* These three inquiries all considered aspects of the way that infrastructure businesses should be regulated. Key areas of common importance arising from these reviews include:

- the need for consistency across the energy industry of the objects clause and pricing principles as proposed within the *Trade Practices Amendment (National Access Regime) Bill 2005*
- the need for consistency of approaches and methodologies with the regime's objects clause and pricing principles
- the benefits of providing a lighter-handed option of price-monitoring

Key findings arising from these reviews include a need to focus on:

- encouraging efficient investment in new infrastructure
- encouraging efficient use of current investment
- the long-term interests of consumers in adequate infrastructure provision, not the short-gains of price reductions
- improving the certainty, transparency and accountability of regulatory processes

These developments are discussed in more detail below.

Trade Practices Amendment (National Access Regime) Bill 2005

This inquiry conducted by the Senate Economics Legislation Committee in July 2005 – *Inquiry into the provisions of the Trade Practices Amendment (National Access Regime) Bill 2005 (the Bill)* accepted the Australian Government's proposed objects clause and the Australian Government's Pricing Principles as provided within its response to the Productivity Commission's *Review of the National Access Regime* (PC's review of the NAR) which were of significant importance in improving the certainty and transparency of the regulatory process. This prompted the Committee to advise that the Pricing Principles be included within the Bill, instead of within a legislative instrument.

In the PC's review of the NAR, the PC concluded that an objects clause was necessary to capture the intent of Part IIIA. The PC's proposed objects clause was very similar to the final objects clause proposed by the Australian Government, and the objects clause inserted into the Bill, which states:

The objects of this Part are to:

(a) promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and

(b) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry[1]

The Pricing Principles within the Bill are designed to make operational sense of the objects clause, their role is to rule out approaches and methodologies which would be inappropriate.

Within the Government's response to the Productivity Commission's Report, the Government stated that the above objects clause within Part IIIA is to provide a consistent national framework for infrastructure regulation and should play a guiding role in relation to each decision-maker's approach to enhance regulatory accountability[2].

In ENA's view, the National Electricity Rules need to be amended to maintain consistency with the object and pricing principles of Part IIIA.

Prime Minister's Exports and Infrastructure Taskforce Report

The Prime Minister's Export Infrastructure Report concluded that for export infrastructure there should be a presumption that pricing and associated issues should be resolved by commercial negotiation between the infrastructure provider and user. If this is found to be inappropriate, then a presumption of light-handed monitoring should apply, that is, price monitoring. Only if this has demonstrably failed, than intrusive (heavy-handed) forms of regulation should be introduced.

The Report recommended that if heavy-handed regulation is found to be necessary, then the following restrictions should be introduced:

1. A stream-lining of processes as well as certainty of time limits.

2. Regulators should apply a simplified test when assessing a proposal by an infrastructure owner, that is, a reasonable range test. If the proposal is reasonable within the particular commercial circumstance, then this proposal cannot be rejected just because the regulator may prefer another point on the range.

3. For all regulatory decisions involving terms and conditions of access, a limited form of merits review should be available.

The Report concluded that it is imperative that regulators do not exchange short-term gains of low prices for consumers for the long-term sustainability of the infrastructure[3]. In light of this, the Report stressed the importance of the objects

[1] *Trade Practices Amendment (National Access Regime) Bill 2005,* p.4, at http://parlinfoweb.aph.gov.au
[2] Australian Government *Government Response to the Productivity Commission Report on the Review of the National Access Regime,* p.3, at http://www.treasurer.gov.au
[3] Exports and Infrastructure Taskforce *Australia's Export Infrastructure Report,* May 2005, p. 40-41

clause within Part IIIA of the *Trade Practices Act 1974* as clarified by the Australian Government. It is imperative that the Part IIIA interpretation of economic efficiency is the overriding objective of access regulation[4]. When consideration is being given to the revision of the National Electricity Rules, it is essential that the amendments are consistent with the Part IIIA objective and not create a 'laundry list' of additional, inconsistent guiding principles.

Productivity Commission *Review of the Gas Access Regime*

The Productivity Commission Review (PC Review) recommended that the Gas Access Regime include an overriding objects clause consistent with the Australian Government's proposed objects clause which incorporates the need for efficient investment, operation and use of transmission pipelines.

The Ministerial Council on Energy (MCE), in its recent *Consultation paper on the Review of the National Gas Pipelines Access Regime* also agreed that an objects clause was essential, although it has recommended a different version of the objects clause to that proposed by the Productivity Commission.

The MCE stated that it agreed with the PC's concerns to ensure consistency between the objects clause that is included in the National Access Regime and those contained in sectoral regimes. The MCE considers consistency across the energy sector to be an even higher priority in recognition of the strong commercial linkages within the energy sector.

The MCE also agreed with the PC's view that a light-handed monitoring option of regulation should be available which would comprise of monitoring with dispute resolution as a fallback.

4. Scope and form of regulation

Within the policy context of the above three reviews, all reviews support a flexible approach to regulation of services and assets ranging from the negotiate/arbitrate model where sufficient competitive forces exist, to light- and heavy-handed regulation.

The price-monitoring form of regulation warrants further attention within this Review. In cases where heavy-handed regulation currently exists, a revision of the necessity of this form of regulation should be investigated, posing the question as to whether a price-monitoring form of regulation will be practical in the particular circumstances of each type of service. Additionally, consideration of price-monitoring should not be limited to the current Review, but scope should be allowed under the future regulatory frameworks for the regulated businesses to be able to nominate services or assets that they consider no longer require a heavy-handed form of regulation for re-evaluation of the form of regulation that should apply.

Factors that should be considered in evaluating whether an asset or service should be exposed to heavy- or light-handed form of regulation includes the extent to which the

[4] Exports and Infrastructure Taskforce *Australia's Export Infrastructure Report*, May 2005, p. 40-41

service is contestable and the number and negotiating capacity of the customers using the service.

Care needs to be taken in using the criteria of uniqueness of an individual businesses' costs as a factor in deciding the form of regulation that should be applied to it. The suggestion raised in the *Issues Paper* that light-handed regulation should only apply to firms that have similar cost structures is inappropriate.[5] Benchmarking across an industry does have the benefit of a regulator overcoming potential information asymmetry issues, but it will not necessarily be appropriate for regulated businesses. The strong linkage between light-handed regulation and benchmarking seems inappropriate, light-handed regulation can successfully apply without industry benchmarking by requiring appropriate information provision.

5. Performance obligations and incentives

Suggestions have been made within the *Issues Paper* to give transmission network businesses incentives to take into account the potential market impact of their operating decisions.

The main difficulty of providing incentives or penalties linked to market performance is the imprecision involved in linking a business's behaviour to market outcomes. The risk of inaccurately connecting market impact to business performance is high. Numerous external events can contribute to what may seem to be a more significant market impact caused by a particular activity of a business. Distilling the impact of these external events is far from a precise science, unless a clear causal link can be drawn that a business activity has caused a certain market reaction beyond a reasonable doubt, reliance on market outcome linkage has the potential to significantly distort a business's associated incentives or penalties.

This potentially high level of uncertainty is further amplified by the size of inaccurate costs that can be imposed upon a business. The high probability of inaccuracy as well as the significant potential monetary loss associated with it is contrary to the national electricity market objective of encouraging efficient investment in electricity services.

Any Rules which provide incentives to avoid over or under-investment in network services need to be transparent, predictable, and accurately calculated. In addition, they need to be set at levels which mean that potential incentive and penalties are balanced and do not undermine the requirement that businesses have available a forward looking revenue which is at least sufficient to meet expected future costs. They should also be informed by evidence on customer's 'willingness to pay' for any proposed performance levels.

[5] Australian Energy Market Commission *Revenue Requirements Issues Paper*, at p.30

6. Treatment of capital expenditure

From the perspective of distribution businesses, an *ex ante* approach to capital expenditure is the preferred approach to the treatment of capital expenditure. The *ex ante* approach allows for investment certainty which encourages efficient investment. There is a need, however, to provide mechanisms to account for additional investment that was not foreshadowed at the time of the assessment but which is subsequently deemed to be a necessary, efficient investment.

Without making an allowance for unforeseen but efficient investments the *ex ante* approach would have the potential to penalize businesses and undermine investment in critical infrastructure. The risk for businesses is that the regulator will not consider the investment to be an efficient investment, which will result in the business being unable to obtain a return on its invested capital. This risk needs to be mitigated by an ability to re-open the revenue cap if an unforeseen investment requirement arises. A business should also be able to obtain an approval of a defined capital investment project prior to making it in order to provide certainty that the business will receive an appropriate return on the investment. The ENA notes that revisions to the National Gas Code to provide scope for this have been accepted through recent amendments to Section 8.21.

7. Approaches to opening asset bases

Energy network businesses consider that the opening asset base should be established by a 'roll-forward' methodology which takes into account actual capital expenditure and depreciation incurred over the previous regulatory period.

For new assets it should normally be possible to value these assets at the actual construction cost consistent with the approach taken under the National Gas Code (Section 8.12).

The ENA does not consider that providing an option for asset bases to be revalued at the commencement of regulatory period serves any appropriate purpose. Given the wide range of values offered by various forms of asset valuation this flexibility serves to increase uncertainty, with no clear balancing benefit.

Regulatory discretion and revaluations

Turning to the issue of the scope for regulatory discretion in relation to subsequent asset revaluation, the ENA does not consider discretion in this area brings any benefits. Certainty over the regulatory asset base and treatment of additions to the base is a fundamental underpinning of investor confidence that appropriate returns on capital invested will be provided for through access prices. There is no case for the AER to be able to make discretionary downward revisions to regulated asset bases.

Easements and land values

The issue of appropriate treatment of easements and land values is still an area subject to ongoing examination by regulatory bodies and regulated businesses.

Whilst some regulatory decisions have recognised an appropriate allowance should be made for easements and land values, there is not a uniform approach to this issue across Australian regulatory bodies.

The ENA favours the NER recognising this uncertainty as an ongoing area of development, that is, as a possible exception to the general principle that regulatory asset bases should be automatically rolled forward at the commencement of each regulatory period. Scope should be provided for the agreed outcomes of revaluation to be expressed in updated asset bases over time.

8. Determining efficient investment

Energy network businesses support a robust *ex ante* approach to determining efficient investment. Reliance upon *ex post* mechanisms generally fails to provide adequate certainty, and increases regulatory risk.

Ideally, the operation and incentives contained in the regulatory framework itself should provide to all parties a confidence that capital expenditure is being undertaken in a prudent and efficient manner. The framework should be based on efficiency sharing incentives (with 50/50 sharing of the net present value of efficiency gains achieved).

The ENA provides no comment on the issue of the Regulatory Test, as this is primarily an issue of relevance to electricity transmission businesses.

9. Operating expenditure

The ENA considers that it is appropriate for Chapter 6 of the NER to provide some limited guidance to the AER regarding approval of forecast operating expenditure programs.

The type of guidance necessary in this regard may be similar to Section 8.36 and 8.37 of the National Gas Code, which is non-prescriptive in form.

Benchmarking will continue to be a tool available to regulatory bodies in assessing proposed costs by service providers. It is important that any recognition of benchmarking approaches in the NER fully and rigorously recognises the significant limitations of this methodology (possibly requiring quantitative identification of the limitations and imprecision), and the possible introduction of regulatory risks through inappropriate use.

10. Rules for rate of return provisions

The ENA considers that rate of return provisions of the National Electricity Rules should provide clear guidance regarding the appropriate approach to establishing an appropriate rate of return on existing assets.

Appropriate form of rate of return provisions

Regulatory rate of return provisions should:

- focus on the objective of ensuring a commercial rate of return is provided on sunk capital assets
- recognise that point estimates of regulatory rates of return fail to allow for the theoretical and practical limitations in current models used to establish expected returns

The Productivity Commission *Review of the Gas Access Regime* considered the issue of improving the operation of provisions of the National Gas Code relating to establishing rates of return in its June 2004 final report. The Commission recommended that amendments should be made to the key regulatory rates of return provisions of the Gas Code. The Commission's recommendation is set out below:

> *Recommendation 7.9*
>
> *To ensure regulators are given clear guidance about the uncertainty associated with calculating an ex ante regulatory rate of return, s.8.31 of the Gas Code should be changed to the following:*
>
> *s.8.31 If a Rate of Return is used in determining a Reference Tariff then the method used to calculate the Rate of Return and the values used in applying that method shall in the first instance be proposed by the Service Provider. In assessing the Service Provider's proposal the Relevant Regulator must take account of the fact that there is no single correct method to determine a Rate of Return and there is often a range of plausible estimates that could be used in applying a Rate of Return method. The role of the Relevant Regulator is therefore to assess whether the Service Provider's:*
>
> *(a) proposed method has a plausible conceptual basis; and*
>
> *(b) values used in applying the method lie within the range of plausible estimates.*
>
> *The Relevant Regulator must approve the proposed method if (a) is satisfied. The Relevant Regulator must approve the values used in applying a method if (b) is satisfied.*

The ENA considers that similar provisions are appropriate for inclusion in the National Electricity Rules. The recommended provision provides the strong benefit of clarifying the role of the regulatory body in making assessments on regulatory rates of return. In particular, it makes clear that the regulator is not required to make a point estimate of a particular 'correct' cost of capital value, a task which the limitations of existing theoretical models makes unachievable.

Adoption of this recommendation in electricity would enhance consistency between gas and electricity regulatory regimes, as the scope of the regulatory task under the Gas Code is already to 'approve' a regulatory rate of return proposed by the service provider which is consistent with Section 8.31 of the Code. It would also represent an evolution from 'first-generation' regulation which relied exclusively upon a regulatory body being required to make a large number of highly discretionary judgements in an environment of incomplete theoretical or practical evidence. As identified by the Productivity Commission and the Prime Minister's Infrastructure Taskforce the tendency for such regimes is to encourage a focus on finding a single "correct" regulatory outcome, leading to delays and unnecessarily costly regulatory processes.

Further prescription in rate of return provisions

The ENA does not support the insertion of prescriptive provisions into the NER relating to how the cost of capital should be established.

Increasing the level of prescription by inclusion of detailed formulas or by establishing default values in legislative rules has several significant disadvantages.

This approach would:

- entrench a reliance on variants of cost of capital models which may be revealed through time to be deficient
- provide little flexibility for regulatory approaches to cost of capital assessments to take into account new information or regulatory developments
- magnify the potential cost of regulatory error and the risk of investment distortion by making it more probable that erroneous approaches of cost of capital input parameters are applied to a large set of assets
- in many cases be inconsistent with the theoretical basis of the underlying asset pricing model and inherent fluctuations of capital markets (e.g. establishing a default 'locked in' market risk premium is inconsistent with the variability of investor expectations)

Similar considerations apply in respect of the issue of prescribing particular types of cost of capital approaches (such as post or pre-tax, nominal or 'vanilla' approaches). Prescribing in detail particular cost of capital approaches and even, potentially, parameter inputs, may have some benefits in offering certainty to existing and potential investors. However, the ENA does not consider these benefits are outweighed by the disadvantages discussed above. In practical terms, there may be opportunities to capture many of these benefits through alternative mechanisms, such as the provisions under the Gas Code for a service provider to put forward long term 'fixed principles' applying across multiple regulatory periods.

The ENA has significant concerns regarding the proposal for periodic review of cost of capital parameters to apply generically across all businesses regulated under Chapter 6. This would result in service providers being required to be involved in two significant regulatory processes (the generic cost of capital process and a firm specific review of terms and conditions), while magnifying the scope and impact of any regulatory errors made in the cost of capital determinations.

11. Regulatory process and discretion

Timing issues and regulatory processes

The ENA supports arrangements which facilitate timely regulatory decisions, recognising the balance with flexibility of regulatory procedures which the *Issues Paper* identifies.

Extensive analysis of mechanisms to promote timely regulatory decision-making has been undertaken in the Productivity Commission's *Review of the Gas Access Regime*. Energy network businesses consider these findings should be incorporated into any AEMC rule making in the area of regulatory procedures and timelines.

For the reasons discussed in the final report of the *Review of the Gas Access Regime* energy network businesses do not support the concept of 'backdating' reference tariffs. However, it is considered that the principle that regulatory decisions involving new reference tariffs should take effect even where the relevant regulatory decision is subject to review is sound and should be a feature of the NER.

The ENA considers a 12 month time frame as an appropriate period for regulatory decisions to be made. Extensions should only be allowed where appropriately justified.

Sequential versus concurrent reviews

The ENA does not support the concurrent undertaking of multiple reviews across jurisdictions by the AER. Existing sequential reviews have the benefit of lowering regulatory risk by allowing for continuous development of regulatory practice to take into account new information and developments, while providing a stable workload for the AER's existing regulatory resources.

Simultaneous reviews would raise significant issues regarding the likely quality of each regulatory decision and its capacity to genuinely reflect individual firm-specific or jurisdictional circumstances. In addition, the AER may find it difficult to attract and retain relevant expertise during the periods between these concurrent reviews.

Basis on which the AER may reject or modify a proposal

Energy network businesses support the movement of energy access rules towards a 'propose-respond' model in which a regulatory body would not have discretion to reject an access proposal which met the requirement of the relevant access rules.

The ENA notes that this model is supported by a wide range of policy developments, including the recently implemented *WA Electricity Network Access Code*, and the review by the Productivity Commission of the operation of the National Gas Code.

As discussed previously, the Prime Minister's Export Infrastructure Taskforce also concluded earlier this year that a 'propose-respond' model where an access proposal could only be rejected or modified by a regulatory body in a defined range of circumstances represented best practice access regulation.

Reasonable ranges and access regulation

Requiring acceptance of a service providers' proposal if it falls within a reasonable range is a positive way of recognising the potential for error, and the asymmetric impacts of regulatory error, on new and ongoing investment in critical energy infrastructure.

Reasonable ranges and regulatory certainty

Providing for recognition of reasonable ranges in the regulatory framework is consistent with placing weight on regulatory certainty.

Regulatory certainty is not enhanced by regulatory bodies seeking to reach the 'best' or 'central' estimate of an appropriate cost of capital, as existing models do not provide any clear basis for the selection of any single point estimate. Regulatory interpretations of what values represent the 'best estimates' can and have varied through time, undermining the argument that certainty and predictability is enhanced through maximising regulatory discretion in this area. On the other hand, existing models do provide a fairly robust potential range of cost of capital values. While establishment of point values for upper and lower boundaries of reasonable ranges (assuming this was necessary) could present some challenges it is difficult to sustain a case that estimating a single point estimate which balances all of the uncertainties of multiple cost of capital inputs is a simpler, more robust, replicable and certain process. A reasonable ranges approach provides perspective on realistic levels of precision and reduces arbitrariness.

There is no evidence that an approach which recognises 'reasonable ranges' would imply more disputes or reduce certainty. The Productivity Commission's *Review of the Gas Access Regime* considered this approach would reduce regulatory disputes relating to cost of capital and enhance certainty for investors. The Commission's recommendations in this area sought to provide *greater* clarity over the appropriate role of the regulator in approving rates of return under the gas access regime, a key issue considered by the Australian Competition Tribunal in the *GasNet* ruling. The Commission's report considers that ruling, and provides in response recommendations intended to explicitly clarify the operation of the relevant Code provisions. Against this background an assertion that providing such clarity might induce greater disputes or uncertainty is both paradoxical and unsustainable.

Any contention that a 'reasonable ranges' approach could imply more disputes is also not supported by any evidence from the recent operation of the gas regime. Since the *GasNet* decision in 2003 seven gas network and transmission pricing reviews have occurred that reference and integrate the key outcomes of the *GasNet* rulings. None of these decisions have been subject to review primarily focused on the issues associated with regulatory discretion in approving appropriate rates of return.

Use of reasonable ranges by existing regulatory agencies and frameworks

Actual regulatory practice in a number of jurisdictions and infrastructure regimes has recognised the existence of reasonable ranges. For example, the South Australian Essential Services Commission's carried out detailed analysis of the implications of *GasNet* and other review rulings in its recently issued guidance paper for the review of Envestra's South Australian gas access arrangement.[6] Other recent regulatory

[6] See Essential Services Commission of South Australia *2006 Review of Envestra's Gas Distribution Access Arrangement – Guidance Paper*, August 2005 and *2006 Review of Envestra's Gas Distribution Access Arrangement - Discussion Paper*, May 2005

decisions have also integrated considerations of reasonable ranges and the scope of regulatory discretion into multiple draft and final decisions.[7]

Alternative 'wide discretion' model

The alternative to a 'reasonable range' approach is the proposition that regulators should be empowered to make the 'best' decisions they are able.[8] This alternative 'regulator determination' approach substantially increases the scope of regulatory discretion. Notwithstanding that providing wide discretionary scope for regulatory bodies is a model favoured by some regulatory bodies, this is a crude 'first generation' regulatory model which fails to reflect the experience of a decade of infrastructure regulation. The consequences of this approach are significant regulatory uncertainty (since discretion to amend the service provider's access proposal is effectively unfettered), potentially discouraging new and ongoing investment in critical energy infrastructure. Wider regulatory discretion *creates* rather than resolves issues of uncertainty.

Empirical evidence suggests that the operation of a 'propose-respond' which incorporates the concept of reasonable ranges in gas is associated with shorter pricing review processes compared to the open-ended regulatory discretion present in relation to electricity network tariff determinations. For gas networks, operating under a model which defines the scope of regulatory discretion, the average time taken for a price review process is 12 months. For electricity, which operates under a model featuring wide regulatory discretion - where the regulator determines rather than approves access terms and conditions - the average is 19 months.

Impact of movement to a reasonable ranges approach

Finally, the ENA notes extensive and repeated representations made by regulatory bodies that current regulatory decisions already reflect an 'erring' on the side of service providers, or a cautious approach which places emphasis on the long term interests of consumers in new and ongoing investment. These claims appear to be in tension with the alternative model of the NER requiring regulator to make a 'best' or 'central' estimate.

It is noted that there is an inconsistency in regulatory agencies simultaneously claiming that a weakness of a 'reasonable ranges' approach is that it may result in consistently upwardly 'biased' rates of return for service providers, and the assertion by the same agencies that they already effectively bias their decision in this manner as a matter of practice.[9] Accepting regulatory agencies claims that regulatory rates of return are already 'generous' or determined with reference to a highly conservative set of assumptions implies that movement to a 'reasonable ranges' approach may have little or no impact in the level of applicable regulatory rates of return. The ENA considers Section 8.6 of the Gas Code[10] to be a successful example of applying a reasonable range to determine an appropriate rate of return where the 'reasonable range' approach is not only applied to building blocks but also to the total revenue.

[7] For example, see recent gas distribution price review decisions by the WA Economic Regulatory Authority, ACT Independent Competition and Regulatory Commission and NSW IPART.
[8] MCE Standing Committee of Officials *Consultation Paper - Response to Review of National Gas Access Regime*, August 2005 p.20
[9] Victorian Essential Services Commission *Review of Gas Access Arrangements, October 2002*, p.146.
[10] *See Section 8.6, National Third Party Access Code for Natural Gas Pipeline Systems*