Independent Pricing and Regulatory Tribunal

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Your reference:

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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Dear Mr ~~Pierce~~ John

DRAFT RULE DETERMINATION - PROPOSED CHANGES TO THE NATIONAL ELECTRICITY AND GAS RULES

IPART welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Draft Rule Determination (draft determination) on the economic regulation of network services under the National Electricity Rules (NER) and National Gas Rules (NGR).

As you know IPART has concerns that network price increases in NSW may be higher than necessary due to certain aspects of the regulatory framework, including the economic regulation of the networks under the Rules and the Limited Merits Review regime, as well as governance arrangements for State-owned businesses in NSW.

We support the changes proposed by the AEMC to improve the NER and NGR by encouraging more holistic, balanced decision making, that focuses on overall outcomes.

While we support your draft determination we recommend:

- Strengthening the ex-post review provisions to provide stronger incentives for NSPs to invest efficiently so that customers only pay for capital expenditure that is efficient and prudent; and
- Ensuring that the determination processes under the transitional arrangements and the new network rules are completed earlier so that annual network prices can be proposed and approved at least 2 months before they take effect.

We consider that the AEMC's proposed amendments to the NER, enhanced by a stronger ex-post review and earlier approval of annual network prices, coupled with improvements to the Limited Merits Review regime[1] should result in outcomes that are in the long term interests of customers.

1 IPART considers that the Limited Merits Review regime should be changed to ensure that the appeal body is capable of balancing competing interests and exercising discretion in the context of an overall regulatory objective.

Establishing an overall objective alongside a set of regulatory 'tools' are likely to improve the efficiency of capital expenditure

The NSPs in NSW spent significantly more than their capital expenditure allowances over the period 2004/05 to 2008/09, and significantly more than they proposed to the regulator.

We support the AEMC's draft amendments to:

- establish an overall capital expenditure incentive objective that explicitly states that customers should only pay for capital expenditure that is efficient and prudent
- empower the regulator with a set of 'tools', including an ex-post review, which it can apply as it considers necessary to provide adequate incentives for NSPs to spend capital expenditure efficiently, having regard to the overall capital expenditure objective. The suite of capital expenditure incentive mechanisms will evolve over time as changing circumstances require
- require the regulator to set out its approach to capital expenditure incentives in guidelines, including how it proposes to undertake ex-post reviews of capital expenditure, and to outline how the combination of 'tools' best meets the capital expenditure objective
- require the regulator to make a statement on the efficiency of past capital expenditure, and the efficiency of capital expenditure being rolled into the RAB.

We consider that the AEMC's draft amendments will:

- provide additional incentives for NSPs to incur capital expenditure prudently;
- partly protect customers from paying for inefficient capital expenditure, where other capital expenditure incentives (such as the ex-ante incentives) may not be sufficient to encourage efficient expenditure, for example, in situations where governance arrangements may not provide sufficient discipline;
- improve public confidence that the delegated decision making process (the regulator operating under the NER) is leading to outcomes that are in the long term interests of customers

The design of the ex-post review mechanism can be improved to better meet the proposed objective for capital expenditure incentives

We consider that the ex-post review mechanism should be strengthened to:

- provide stronger incentives for NSPs to invest efficiently to avoid unnecessary investment and declining levels of productivity in the electricity sector, particularly where the shareholder and governance framework for NSPs may not be provide effective financial incentives.

- to ensure that customers only pay for efficient and prudent expenditure in line with the AEMC's proposed objective for capital expenditure incentives.

The AEMC's draft amendments restrict the regulator to excluding only inefficient capital expenditure from the RAB that is **above the original allowance.** This:

- introduces an asymmetry in the review, particularly where capital expenditure depends on external factors, and the allocation of costs to customers. It is important to recognise that the level of capital expenditure incurred by a prudent NSP, that regularly reviews and reassesses its capital expenditure program, may be significantly different from that determined by the regulator to be reasonable at the start of the regulatory period. This is because changes to the external environment should lead a NSP to regularly review and reassesses its capital expenditure program based on the most up to date forecasts of demand.[2]
- alters the incentives for the NSP and the regulator as part of the initial determination of capital expenditure and the incentives for the NSP during the regulatory period. At the margin, a NSP is incentivised to propose a higher level of capital expenditure if the ex-post review is limited to excluding only inefficient capital expenditure from the RAB that is **above the original allowance.** Similarly the regulator may be more inclined to approve a lower level of capital expenditure.

We are of the view that the ex-post review should not be limited to excluding only inefficient capital expenditure from the RAB that is above the original allowance given that:

- there is no systematic reason why changing external circumstances should not also lower capital expenditures.
- it is important to provide stronger incentives for NSPs to invest efficiently, particularly where the shareholder and governance framework for NSPs may not provide effective financial incentives
- the AEMC's proposed ex-post review mechanism alters the incentives for the NSP and the regulator as part of the initial determination of capital expenditure and the incentives for the NSP during the regulatory period
- the allocation of risk, in terms of who bears the impact of changes in costs resulting from external environment, should be symmetric if the ex-post review is to be consistent with the AEMC's capital expenditure objective; namely that customers only pay for efficient and prudent expenditure.

This is particularly relevant given that we are in an environment of declining electricity demand (relative to the high growth forecasts underpinning the recent determinations). NSPs need to be provided with strong incentives to review and reassess capital expenditure

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2 AEMC, Draft Rule Determination – Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, p142.

programs during this period. All else being equal, electricity prices in the next regulatory period might be lower, allowing customers to benefit from reductions in capital expenditure.

We are of the view that concerns about investment certainty and regulatory risk could be better addressed through guidelines published by the regulator, including:

- the approach it intends to apply in undertaking its ex-post reviews
- how the approach will balance providing confidence to industry about their ability to recover investments, the need to promote dynamic efficiency and the overall objective of ensuring that customers only pay for efficient and prudent capital expenditure.

The AEMC's draft determination intends to encourage more holistic, balanced decision making, that focuses on overall outcomes. That is, prescribing the regulatory objectives that the regulator should seek to achieve in making its decisions, rather than prescribing the methodologies the regulator should use. We consider that restricting the regulator to excluding only inefficient capital expenditure from the RAB that is above the original allowance is potentially inconsistent with this approach.

Prior to making a final determination we encourage the AEMC to consider the extent to which there are alternative ways of providing investment certainty while ensuring customers only pay for efficient and prudent capital expenditure. There is a risk that prescribing a narrow ex-post review in the NER may limit the ability of the regulator to evolve the suite of capital expenditure incentives through time in response to changing circumstances. For example, the importance of dynamic efficiencies and the need for investment certainty to encourage these efficiencies may change through time. It is likely that the regulator is better placed to consider this issue within the context of its overall capital expenditure incentives and the regulatory decision.

Bringing forward the regulatory determination process will increase the ability of retailers and customers to respond to price signals

We support measures to improve the credibility, transparency and accessibility of the regulatory determination process, subject to their cost and effectiveness in improving regulatory outcomes.

While increasing the time for reviews to be undertaken can have benefits in terms of improved opportunity for stakeholder involvement, consideration also needs to be given to the benefits of completing the process earlier so that annual network prices can be proposed and approved 2 months before they takes effect.

The current provision in the NER leave little time for retailers to understand the annual changes in network prices and for regulated retail prices to be proposed and approved by jurisdictional regulators, and even less time for the retailers to develop their market offers (often having regard to the regulated retail prices). There is little, if any, time for customers to be notified of retail prices before they commence.

As you know, we have proposed a change to the NER to improve the process by which annual changes in electricity network prices are proposed and approved. The proposed rule change is intended to:

- provide greater consultation to allow customers to better understand any proposed changes and to provide retailers with greater opportunity to understand the impact of any network changes on their pricing strategies and to develop their retail prices; and
- allow greater consultation on retail price changes and for customers to receive earlier notification of the change to their prices.

We support completing the determination process earlier so that annual network prices can be proposed and approved 2 months before they take effect. This will increase the ability of retailers and customers to respond to price signals, and in turn will promote efficient investment in and use of the electricity supply system. It will also improve the retail market by providing retailers with additional time to consider network pricing in developing retail prices, to make changes to billing systems where necessary, and to notify customers of changes to retail prices.

The AEMC has proposed arrangements to transition a number of NSPs to the new network rules.[3] Under the proposed transitional arrangements, final regulatory determinations to apply for 2014/15 would be published at the end of April 2014. We are concerned that this would leave little time for annual network prices to be proposed and approved. As outlined above, we support completing the determination process earlier so that annual network prices can be proposed and approved at least 2 months before they take effect.

Clarifying the regulator's 'rights' and 'obligations' in determining capital and operating allowances is likely to lead to a better estimate of efficient costs

We support the AEMC's proposed amendments to clarify the regulator's 'rights' and 'obligations' in determining capital and operating allowances. The AEMC's proposed amendments clarify that the intent of the NER is to provide regulators with appropriate discretion to set capital and operating allowances at efficient levels, assuming the regulator has adequate information and uses appropriate analytical techniques.

We support the AEMC's proposed amendments to clarify that:

3 AEMC, Consultation paper on savings and transitional arrangements – Draft National Electricity Amendment Rule 2012, 14 September 2012.

- benchmarking and a range of other tools should be used to assess the efficiency of NSPs and whether the proposed allowances are reasonable. That is, regulators should not be limited to assessing a proposal on the basis of a 'bottom up' engineering based approach
- the best outcomes will be achieved if the regulator is provided with the flexibility and discretion to alter their approach through time as circumstances change and new models or methods for estimating and testing proposed allowances emerge
- the regulator should determine a substitute amount on the basis of the information it has, and should not be restricted in terms of adjusting the amount to the minimum extent necessary.

Establishing an overall rate of return objective is more likely to facilitate a better rate of return estimate

We share the AEMC's concerns that the current provisions in the NER are overly prescriptive and limit the discretion of the regulator in determining the rate of return, particularly as circumstances change. This could lead to outcomes that may not be consistent with the long term interests of customers.

We support the AEMC's proposed amendments to enable the regulator to make the best possible estimate of the rate of return at the time a regulatory decision is made. Specifically we support:

- establishing an overall rate of return objective focussed on the rate of return required by a benchmark efficient service provider with similar risk characteristics as the service provider subject to the decision
- providing flexibility and discretion for the regulator to alter its approach as circumstances change and new models or methods for estimating components emerge
- encouraging the regulator to be consultative in developing its approach

If you have queries regarding this submission, please contact Alexus van der Weyden on 9290 8460 or Anna Brakey on 9290 8438.

Yours sincerely

Peter J. Boxall

Peter J. Boxall AO
Chairman