**The Hon Tom Koutsantonis MP**
**Member for West Torrens**

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**Government of South Australia**

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

Thank you for the opportunity to comment on the Australian Energy Market Commission's (AEMC) Consultation Paper: *Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011.*

As Minister for Mineral Resources and Energy I feel it is important that any price rises resulting from service charges for the use of transmission and distribution electricity networks, which together represent about half of a customer's power bill, are based upon efficient expenditure to meet customer's energy needs.

It is important that the economic regulatory regime for electricity network service providers allows them to receive sufficient revenue to supply key services, meet the costs to operate and maintain reliable networks, meet peak demand and replace equipment that has reached the end of its useable life.

The peakiness of South Australia's demand is amongst the highest in Australia, and the State has one of the oldest electricity networks on mainland Australia. Accordingly, future investment in electricity assets will be required in the State to maintain supply reliability and to meet demand. Importantly, the framework will also need to efficiently manage peak demand growth.

It is important however, that the economic regulation framework ensures that South Australia's electricity customers are only required to meet the costs of an efficient service provider.

The Australian Energy Regulator (AER) has now completed a full round of regulatory determinations and reviewed the regulatory regime against the previous State-based regimes. Accordingly, it is appropriate that the AER has undertaken a review of the operation of the framework and proposed Rule Changes it considers necessary to ensure the intention of the framework is achieved.

Equally, the South Australian Government encourages customer engagement in determining appropriate framework settings. It is therefore encouraging that the Energy Users Rule Change Committee has undertaken an assessment of the frameworks and proposed a Rule Change to address what the Committee considers to be flaws in the current framework.

The South Australian Government encourages the AEMC to assess the existing framework and AER proposed Rule Change to determine the appropriate framework settings to balance the provision of sufficient revenue for the network service providers to provide reliable and secure electricity supply, whilst ensuring consumers are contributing no more than required for an efficient service provider.

The Department for Manufacturing, Innovation, Trade, Resources and Energy (DMITRE) reviewed the AEMC Consultation Paper and the proposed Rule Changes. The Department has developed more detailed comments which are attached for the AEMC's consideration. Should you have any questions about this submission, please contact Mr Vince Duffy, Executive Director, Energy Markets and Programs Division of DMITRE on (08) 8204 1724.

Yours sincerely

**Hon Tom Koutsantonis MP**
Minister for Mineral Resources and Energy

23rd December 2011

Attach: submission from the Department for Manufacturing, Innovation, Trade, Resources and Energy

Government of South Australia
Department for Manufacturing, Innovation, Trade, Resources and Energy

Reference: ERC0134

**Department for Manufacturing, Innovation, Trade, Resources and Energy (DMITRE) Submission to the Australian Energy Market Commissions (AEMC) Consultation Paper: Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011.**

The Energy Markets and Programs Division (the Division) of DMITRE provide comments in regards to the regulatory regime as applied to the two privately-owned monopoly network service providers operating in the South Australian electricity transmission system (ElectraNet) and electricity distribution system (ETSA Utilities).

## Expenditure Framework and Regulatory Processes

The economic network regulation framework should allow network service providers to recover the efficient costs that a prudent network service provider would incur in the provision of network services.

The current rules require the Australian Energy Regulator (AER) to accept expenditure proposals from businesses if it is satisfied they 'reasonably reflect' efficient, prudent and realistic expenditure, which the AER considers that they are required to determine that they are 'unreasonable' rather than efficient. The AER has also indicated that they are constrained to providing allowances that are at the top end of reasonable forecasts.

In the drafting of this regime, it is understood that the AEMC sought to recognise concerns of some stakeholders that regulators might attempt to achieve a level of precision in setting forecasts rather than recognising that there is a range of possible outcomes. Further, it was considered that in order to promote investment consistent with network reliability, it was necessary to codify that the AER must accept Network Service Providers' proposed expenditure forecast where they satisfy specified criteria. Therefore, the current framework design favours network service providers in an attempt to minimise the risk of under-investment in networks.

The current framework has enabled significant investment in networks to occur and has ensured that network service providers have complied with varying jurisdictional reliability standards.

The AEMC should ensure that a revised framework provides an appropriate balance between network service providers' operational requirements to meet jurisdictional reliability standards and minimising costs to consumers in the long term.

The AER has proposed a decision making test which requires the AER to determine the forecast of expenditure that it considers a prudent and efficient network service provider would require to achieve the objectives. The requirement for the AER to accept a forecast if it reasonably reflects the required expenditure is removed. The Division does not consider that this proposal reflects a balanced position. It is necessary for the framework to ensure the proposal submitted by the network service provider is considered and to provide the AER with the ability to make a decision based on that proposal and other relevant information gathered during the process, for example from benchmarking, that seeks to meet the National Electricity Objective of efficient investment rather than a reasonable test.

Benchmarking provides the ability to use the power of comparison to identify inefficient businesses and to provide expenditure allowances. The benchmarking of efficient expenditure was attempted in ETSA Utilities proposal to the AER for its 2010-2015 Regulatory Determination where they put forward an expenditure benchmarking ratio of capital expenditure (capex) to their Regulated Asset Base (RAB) and their ratio of operating expenditure (opex) to their RAB. In that respect, ETSA claimed it had the lowest capex/RAB and opex/RAB ratios amongst Australian distributors, circa 2008.

The Division considers that one of the most significant benefits of a national regulator is that by undertaking determinations for all the network businesses, there is a significant opportunity to benchmark efficient levels of expenditure with a range of benchmarks needing to be evaluated and tested.

It is understood that the AER is working on developing benchmark measures on network service providers' performance and is currently reviewing literature from local and international regulators to form an information base to support benchmarking approaches proposed for adoption by the AER.

With regard to over-expenditure on benchmarks, the Division considers the AER's 60/40 sharing factor is a 'blunt' regulatory instrument that is not the most effective method that is available to discourage network service providers from overspending on capex allowances. In South Australia, there is no evidence for systematic capex overspending, as supported by the actual capex programs from the two regulated monopolies. The AEMC should consider other mechanisms that would provide incentives for network service providers to not overspend, such as the inclusion of ex-post capital expenditure reviews for any expenditure that has not been appropriately justified under the Regulatory Investment Test. It is important to note that the National Gas Rules utilise an ex-post prudency assessment prior to rolling capital expenditure into the asset base at the start of the next regulatory period. It is vital that perverse incentives are not created to not undertake expenditure required to provide reliable supply.

The Division fully supports the AER proposal that distribution network service providers are able to access the same mechanisms for dealing with uncertainty as transmission network service providers have via contingent projects. An example of a potential contingent project for ETSA Utilities would have been the undersea power cable to Kangaroo Island (KI) and associated network augmentation, rejected by the AER in ETSA Utilities' 2010-15 regulatory determination. In this case, the AER concluded that the KI project expenditure had not been demonstrated to be prudent or efficient, whereas in fact, the project involved a replacement undersea cable and associated island network augmentation to provide continuous supply in the event that the existing undersea cable failed as it approached its physical and end of expected operating life. As a contingent project, ETSA Utilities may have provided further information that could have met an appropriate trigger event to enable the project to proceed in a similar manner to the CBD augmentation for ElectraNet.

**Cost of Capital**

The Division supports alignment in the manner in which the weighted average cost of capital (WACC) is determined across transmission and distribution. The proposed process requires the WACC to be calculated in accordance with the 'Statement on the Cost of Capital' for both electricity transmission and distribution to replace the current Statement of Regulatory Intent. Fixing the value of WACC in advance of all the distributor determinations within the five year period of WACC Reviews should improve consistency in the application of WACC, although it is recognised that market conditions will continue to influence WACC values over time.

Network service providers should have access to an appeals mechanism, in particular, to any address identified errors. An observation from South Australia under the current regulatory regime was that ETSA Utilities challenged the AER in its 2010-15 determination in the ACT over gamma, which directly affects the WACC. The AER determined a gamma value of 0.65, which was higher than prescribed in the National Electricity Rules of 0.5, but the ACT ruled a gamma of 0.25 which resulted in increased costs being passed through to South Australian consumers.

Regarding Debt Risk Premium (DRP), the Division considers the DRP should be set in the same manner for all network service providers so that it is consistent with best practice regulation, regardless of ownership structure of the network service provider.

The AER's proposal for the new method of determining DRP (designed during the WACC Review), would mean that the values of the other WACC parameters (equity beta, market risk premium, gamma and debt to equity ratio) would be removed from the National Electricity Rules and established at the WACC review. Analysis of DRP values in South Australian regulatory determinations under the previous and current regulatory regime indicates that the methodology for determining DRP varies with each determination, with a contributing factor being a lack of data. Further analysis by the AEMC should seek to establish the principles by which the DRP would be determined.

**VINCE DUFFY**
**EXECUTIVE DIRECTOR**
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**6 / 12 /2011**