SP AusNet™
A member of Singapore Power Group

4 October 2012

John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear John,

Re: Draft Rule Determinations: Economic Regulation of Network Services

SP AusNet welcomes the opportunity to make this submission in response to the AEMC's Draft Determination on the following consolidated Rule Change Proposals:

- National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011

- National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2011

- Calculation of Return on Debt for Electricity Network Businesses Rule 2011

SP AusNet considers that the Rules established for the economic regulation of network services have worked well for the revenue and price reviews of each of the company's electricity transmission network, electricity distribution network, and gas network. The transmission and gas networks are currently subject to a second round of revenue / price reviews under the Rules (draft decision released for the gas network on 11 September 2012 and regulatory proposal for transmission network due on 28 February 2013).

The key principles of the revenue-setting framework, which also includes the existing limited merits appeal regime, are sound. They provide the necessary accountability on the regulator to make good decisions, and confidence to investors for the protection of sunk investment, and encouragement of future investment. These fundamental features of the regulatory regime are necessary for a sustainable energy sector in the long-term interests of consumers and care must be exercised to ensure they are not weakened.

Nevertheless, given its experience in applying the Rules, and having regard to the debate that has occurred in the course of the AEMC's review, SP AusNet agrees that the Rules can be improved in a number of ways to contribute to the national electricity and national gas objectives. In particular SP AusNet supports measures to improve consumer participation in the revenue setting process, and the publication of annual benchmarking reports which will provide an additional information source on network cost drivers and outturn performance for all stakeholders.

SP AusNet has participated in the development of the industry association submissions made by the Energy Networks Association (ENA) and Grid Australia, and strongly endorses those submissions. The remainder of this submission provides our comments on highest priority areas of interest.

We invite you to contact Kelvin Gebert, SP AusNet's Manager Regulatory Frameworks, ph. 03 9695 6603 for any inquiries regarding this submission.

Yours Sincerely,

Alistair Parker
Director, Regulation and Network Strategy

Attachment:

Submission on Draft Rules Determinations: Economic Regulation of Network Services

Draft Rules Determinations: Economic Regulation of Network Services

1. Accountability within Revenue Setting Framework

The draft determination makes it clear that the AEMC has considered the need for a revenue setting framework that holds parties accountable. The level of guidance provided in the current framework was intentional, designed to facilitate consistent decision-making that would provide investors with confidence that sunk investment is protected, and for the encouragement of future investment necessary to provide the services sought by consumers.

The revenue setting framework operates in concert with the Limited Merits Review Regime, whereby parties may apply for review of a decision on the grounds of error of fact, incorrect exercise of discretion, or unreasonableness of the decision.

The draft determination proposes a dramatic shift in regulatory approach, providing the AER with significant new discretion in the exercise of its powers. The AEMC has noted in the draft determination, at various locations, that regulatory accountability is a key factor in its thinking. Section 6.3.4 for example, contains a sub-section explaining how accountability is achieved in the new common rate of return framework. The accountability mechanisms noted are:

- informing and testing against a range of evidence;
- measurement against the rate of return objective; and
- the publication of guidelines (which are non-binding).

It is noticeable therefore, that in granting increased discretion to the AER, the regulator's accountability will be weighted more toward the reasonableness of its decision making. It is therefore necessary for the overall regulatory system to recognise this change, and ensure that the reasonableness of a decision can be recognised. Without this, accountability will be eroded.

The section of the draft determination referred to above concludes by noting that the proposed rate of return framework *does not alter the service providers' ability to seek merits reviews*. SP AusNet is not convinced that this is a correct assertion.

We therefore consider that further consideration is required in ensuring that the AER may be held accountable for the reasonableness of its decisions in the circumstances that it is able to exercise significantly greater discretion. It is not clear that the application of guidelines can provide this assurance, as it is possible that the guidelines themselves may be contentious.

2. Rate of Return Framework

SP AusNet is broadly supportive of the revised rate of return framework, and considers it makes a significant improvement on the current framework. This includes the overarching rate of return objective, and the requirement for all relevant estimation methodologies, financial models, market data and other evidence to be taken into account.

However, we consider that a number of further improvements within the proposed framework are necessary.

Necessary clarifications

These include clarification of the following matters, treated in more fulsome manner in the ENA's submission:

- A modification to the draft rate of return objective to ensure consistency with other objectives across the broader regulatory framework, and to clarify how the term "efficient" should be applied particularly given that the term appears twice in the draft objective;

- Recognition in the rate of return objective that the rate of return is an estimate, rather than a value that can be determined with precision; and

- Clarification that the WACC to be adopted is a nominal vanilla WACC, rather than a nominal post-tax WACC as stated in the Draft Rules.

Justification for departure from guidelines

The draft determination removes the explicit inertia principle from the rate of return framework. SP AusNet understands the AEMCs rationale in considering that *"…achieving an estimate of the rate of return that best reflects the benchmark efficient financing costs is the overriding consideration for a rate of return framework in terms of achieving the NEO, the NGO and the RPP …".* However we believe the discretion that would be provided to the AER does not place sufficient matching obligation on the AER (or any party) to justify its actions in departing from the accepted position.

We believe that improved confidence in the outcomes from the rate of return framework is necessary, and would be aided by requiring departures to be properly explained, by stating reasons, including assessment of relative merits, and providing evidence in support. The obligation would apply to departure from guidelines by either the AER or the network business. It is also necessary for an obligation of this nature to apply to the AER in periodically setting new rate of return guidelines, and in establishing its initial guideline, i.e. transitioning to the new framework from the Statement of Regulatory Intent.

Finally, we wish to note that these principles relating to departure from guidelines should equally apply to other guidelines prepared under the revenue setting Rules.

Function of guidelines

In describing the function of the rate of return guidelines the Draft Determination observes that "*The Commission anticipates that the guidelines would allow a service provider or other stakeholder to make a reasonably good estimate of the rate of return that would be determined by the regulator if the guidelines were applied".* SP AusNet concurs with the AEMC's stated intention, and indeed, would observe that this capability is absolutely necessary.

However, that the Draft Rules do not support the AEMC's statement intention. The Draft Rules do not outline any level of detail to be developed by the AER in the rate of return guidelines, and in particular there is no requirement for the AER to produce indicative values for the key elements of the rate of return. Stakeholders would be unable to make a reasonable estimate of the rate of return that would be determined by the regulator if the guidelines were applied.

This aspect of the proposed framework, as currently drafted, does not provide the confidence sought by investors. The AEMC's statement of intention must be translated into the drafting of the Rules.

3. Return on Equity

It is important that the Rules that govern the return on equity do not preclude the use of long run average real equity returns to set the benchmark return on equity. This approach is used internationally (for example in the UK and the US) and may offer a useful alternative to the current approaches used in Australia. To this end, references to prevailing conditions should not be absolute but rather should remain one of several considerations when setting the return on equity.

4. Return on Debt

Basis for methodology to be adopted

The consultation on cost of debt carried out by the AEMC late in the previous phase of the rule consultation was in recognition of the varying approaches that different parties who participate in debt-raising consider will best mitigate debt raising risk in their circumstances. Ultimately the Draft Determination has recognised the different approaches that may be most appropriate but has left it to the AER to decide which of these, or any other, approach should be used for a network business WACC determination.

SP AusNet broadly supports the more flexible approach to setting the cost of debt however an important clarification is required in the Rules, such that they must provide for the approach put forward in the service provider's proposal to be the reference point. This is because, as just noted, the methodology aspect is highly business-specific and it is the business that will have the greatest knowledge of its circumstances and embedded financing practices. The service provider's approach should be accepted provided it satisfies the return on debt methodology principles.

We note the concern that has been expressed by various parties during earlier consultation relating to transition. This remains an issue to be adequately addressed, including for the purpose of avoiding potential opportunism. SP AusNet considers that a party that departs from past practice must be required by the Rules to provide compelling justification for its proposal / decision.

5. Capex and Opex Allowances

Expenditure Forecasting Method

The draft determination proposes that the AER should determine the methodologies for preparing expenditure forecasts in the Framework and Approach phase of a price review.

SP AusNet considers that this proposal conflicts with the service provider's sole responsibility for preparing and submitting expenditure forecasts in its regulatory proposal. Expenditure forecasting is conducted as part of the service provider's regular business activity, which will form the basis for the development of its submission. Imposing another methodology would result in duplication, causing confusion, extra regulatory costs and risk sub-optimal forecast outputs. Furthermore, service providers are already strongly incentivised to disclose the best possible information to satisfy the AER of its forecast.

Most importantly, at the Framework and Approach phase, it is necessary for the AER to set out how it plans to assess the expenditure forecasts. This will include information templates required by the AER for this purpose.

SP AusNet also considers that in a cooperative approach to the conduct of the price review it is incumbent on the service provider and AER to meet early in the review process, and periodically, to discuss relevant matters, including the form of outputs from the service providers expenditure forecasting models.

6. Capital Expenditure Incentives

In our response to the AEMC's Directions Paper SP AusNet commented on several capital expenditure incentive framework matters which remain relevant to the consultation at the draft determination phase. These are:

- ex-post review of capital expenditure;
- the interaction of this mechanism with other incentive schemes;
- the flexibility for the AER to use forecast or actual depreciation in rolling forward the Regulatory Asset Base; and
- the introduction of the contingent projects regime for distribution.

In addition we comment on the proposed capital expenditure incentive objective and guideline, and the proposals for the AER to prepare a Capital Efficiency Statement for each network business.

Ex-post Review

The AEMC has proposed a set of incentive 'tools' for the AER to apply, and this includes a capital expenditure efficiency benefits sharing scheme (EBSS) and an ex-post review whereby inefficient expenditure would be disallowed. SP AusNet considers that a well-designed EBSS provides a superior discipline on network businesses to focus on efficient investment.

However the addition of an ex-post review will detract from the effectiveness of the package. This measure will cause significant implementation burden and the prospect of prudent investment being excluded would have the effect of making network businesses more reluctant to invest to efficient levels that are in the interests of consumers. For these reasons SP AusNet does not support the inclusion of an ex-post review.

The highest priority for the design of an ex-post review mechanism is that it be objective. This would require it to measure the prudency of investment decision-making. The review would require the identification of projects that might exhibit inefficiency, the relevant drivers, forecasts and outputs to be assessed, consideration as to whether nonetheless the NSPs decision making was prudent. Significant resource would be required by both the AER and NSPs to undertake this review.

If the AEMC decides to include an ex-post review and expenditure disallowance in the final rule then additional guidance to the AER is necessary in the Rules to ensure that the review would be conducted as a review of the prudency of network business investment decisions and project implementation decision-making.

Interaction of Ex-post Review with other Incentive Schemes

Our earlier submission also noted that that an ex-post review may inadvertently impact on the operation of other incentive schemes, in particular the Service Target Performance Incentive Scheme (STPIS). We note that this matter has not been addressed in the draft Rules Determination.

In Victoria, the STPIS provides the basis by which NSPs respond to consumers revealed preferences for network reliability. The STPIS reward / penalty is symmetric, and for SP AusNet is set at 7 per cent of revenue. Capital expenditure for reliability improvement is accordingly not included in the capital expenditure provision, and may quite reasonably and efficiently lead to a higher level of capital expenditure than the provision. The prospect of ex-post review being triggered by response to the STPIS would undermine the operation of the scheme, and the Rules would need to effectively carve out this potential impact.

Contingency Projects Regime for Distribution

The Draft Rule proposes extension of the electricity transmission contingent projects regime to distribution. SP AusNet believes this would not enhance the regulatory regime.

The approach was adopted in transmission in response to the uncertainty associated with very large and easily separable customer driven projects, often associated with a specific large directly connected transmission customers (for example, generators or smelters). These projects can have significant bearing on the level of capital expenditure in a regulatory period.

SP AusNet has not experienced such concerns as being a characteristic of distribution network capital expenditure forecasting, and does not consider that the AEMC has demonstrated the case either. Unless a clear need and benefits can be demonstrated for this proposal it is likely to only distract from good regulatory process with the only result being an increase in uncertainty, leading to reduced efficiency.

Capital Expenditure Incentive Objective and Guideline

The AEMC has proposed a capital expenditure incentive objective, and we recognise that the intention of this may be to enhance regulatory accountability. However, SP AusNet considers the proposed objective is inconsistent with the Regulatory and Pricing Principles set out in the energy law, and therefore can only lead to increased uncertainty.

In particular the objective appears to be concerned with limiting expenditure entering the RAB, rather than promoting efficient investment. This arises from the objective being backward looking, and applying an inappropriately stringent threshold test. The issues are exacerbated when applied in conjunction with the ex-post review.

SP AusNet considers that the guideline to be produced by the AER, setting out its approach to the application of incentive schemes and mechanisms. Further value may be obtained from the guidelines if the Rules clarify that the AER should include in the guidelines criteria on how it would apply the tools at its disposal in particular circumstances. This would improve the predictability of the regulatory process.

Capital Efficiency Statement

Finally we wish to comment on the AEMC's proposal for the AER to publish a capital efficiency statement for each network business. In SP AusNet's view this additional obligation on the AER would result in significant additional resourcing requirements for both the AER and the network businesses in responding to the AER's considerations.

This further and significant ex-post assessment appears to not fully recognise the value of a well-designed ex-ante incentive. SP AusNet considers it doubtful that the introduction of the ex-post measure would be cost effective. In addition, SP AusNet notes that the benchmarking report to be published annually by the AER will serve to provide an indicator of network business expenditure efficiency.

7. Regulatory Determination Process

Customer Engagement and Regulatory Review Process

SP AusNet agrees with the AEMC that customer engagement in the regulatory review process can be improved. We support the introduction of an Issues Paper phase, and the and a process of submissions and cross-submissions on the draft decision and revised regulatory proposals. Both these steps would greatly increase customer representatives' ability to meaningfully engage in the price review process by providing, firstly, an opportunity for the AER to provide guidance on key issues highlighting important areas of a network's proposal and secondly, a formal interaction and information exchange between the network and customers through cross submissions.

Timing of Regulatory Determination Process

The overall period of the process has been significantly extended in the Draft Determination. This is the result of both additional time provided for some components and the inclusion of new components. We acknowledge that the networks sector has been the proponent of some of the contributing factors.

However, SP AusNet considers that the overall period for an individual will be excessively long to provide timely, relevant decisions and to contain regulatory costs. The outcome is that greater reliance on good judgement on an expanded level of uncertainty, and this risks sub-optimal outcomes and reduced confidence in the process for investors. The potential for a number of risks arise, including the following:

- With an 18 month lag between the time a proposal is submitted and a final decision is made, the bulk of the regulatory submission will be out of date. Allowed expenditures, demand forecasts, labour and materials forecasts may all become irrelevant by the end of the regulatory control period;

- A related risk is that submitted forecasts will be less certain, as they would be submitted earlier. There is accordingly potential for greater dispute over the reasonableness of forecasts;

- The Draft Determination may allow for only the first 3 years of the regulatory control period to be used to represent actuals, leading to reduced confidence in the conclusions to be drawn from outturn performance against the previous determination; and

- The reviews will consume excessive resources simply by virtue of extended time that the review continues on.

Whilst the AEMC notes that the review period is not the longest it has observed amongst various jurisdictions, SP AusNet believes that the AEMC should seek to contain the period as far as is practicable to improve regulatory certainty. This should include a review as to where activities can be carried out in parallel, or overlap, so that the overall period is reduced.