RULE CHANGE

Australian Energy Market Commission

RULE DETERMINATION

National Electricity Amendment (Assumed utilisation of imputation credits) Rule 2012

Rule Proponent(s)

ElectraNet
SP AusNet

20 September 2012

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AEMC 2012, Assumed utilisation of imputation credits, Rule Determination, 20 September 2012, Sydney

About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two principal functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

Summary of the final rule determination

The Australian Energy Market Commission (AEMC or Commission) has determined not to make a final rule in response to the consolidated rule change request on the assumed utilisation of imputation credits applying to transmission network service providers (TNSPs).

This final rule determination outlines why the Commission considers that the consolidated rule change request is unlikely to contribute to achievement of the National Electricity Objective.

Consolidated rule change request

On 18 November 2011, SP AusNet submitted a rule change request relating to the value of the assumed utilisation of imputation credits (gamma) applying to TNSPs under chapter 6A of the National Electricity Rules (NER). On 30 November 2011, ElectraNet submitted a rule change request to the AEMC on the same matter.

The SP AusNet and ElectraNet consolidated rule change request consisted of amendments to clause 6A.6.4 of the NER regarding a change to the value of gamma (proposed rules). The effect of the proposed rules would be to change the value of gamma from 0.65, the current value prescribed in the 2009 review of the rate of return elements, to 0.25.

The Commission assessed the consolidated rule change request on a transitional basis, that is, whether the value of gamma should be amended from 0.65 to 0.25 for the forthcoming revenue determinations for SP AusNet and ElectraNet. The amendments proposed as part of the consolidated rule change request regarding the impact of merits review decisions on the rate of return framework more generally are being considered as part of the AER initiated rule change requests on network regulation [ERC0134].

The Commission's final rule determination

The Commission acknowledges that the current rate of return framework for TNSPs does not provide sufficient flexibility to adapt to changing circumstances.[1]

Notwithstanding, the Commission is not satisfied that the proposed rules providing for a revised gamma of 0.25 to apply to the next revenue determination for SP AusNet and ElectraNet will, or are likely to, contribute to the achievement of the NEO because:

- it is not appropriate for the AEMC to conduct a review of the appropriate value of gamma or any other parameter in the rate of return estimate. Such a review is more appropriately carried out by the AER. The AER as the economic regulator is the organisation that has the responsibility and competence to estimate a rate of return or any specific parameter in a rate of return estimate;

- the framework for calculating the rate of return for transmission businesses is codified in chapter 6A of the NER. The chapter 6A framework requires that all elements of the rate of return (including gamma) be considered as part of a single periodic review to allow an estimate of an appropriate overall rate of return to be made. The rate of return is set for five years. Permitting gamma or any other rate of return parameter to be amended outside of that framework would undermine the integrity of the current rate of return framework and create regulatory uncertainty, thereby resulting in an increase in the regulatory risks faced by network businesses; and

- varying the value of gamma as proposed by SP AusNet and ElectraNet in the absence of analysing its impact on the overall rate of return may result in an underlying change in the incentive arrangements for these network businesses that would not be in the long-term interests of consumers.

The role of the AEMC is to assess and amend the frameworks applicable to market participants under the NER which, for the rate of return framework under chapter 6A of the NER, is currently being undertaken through the rule change requests initiated by the AER.

The problem identified in the consolidated rule change request does not seek to amend these frameworks, but to substitute a single outcome of a review by the AER. The AEMC considers that substitution of a single AER decision is as outlined above inconsistent with the NEO and undermines the overall rate of return framework that applies in Chapter 6A of the NER.

1 AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations, 23 August 2012, Sydney, p. 35.

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1 SP AusNet and ElectraNet's rule change requests

1.1 The consolidated rule change request

On 18 November 2011, SP AusNet submitted a rule change request to the Australian Energy Market Commission (AEMC) relating to the value of the assumed utilisation of imputation credits applying to transmission network service providers (TNSPs) under chapter 6A of the National Electricity Rules (NER). On 30 November 2011, ElectraNet submitted a rule change request on the same matter. These rule change requests have been consolidated and are being treated as one request (consolidated rule change request).

1.2 Relevant background

The consolidated rule change request concerns the value of gamma (γ), which is related to the value of assumed utilisation of imputation credits applying to TNSPs. To assist in understanding the context for the consolidated rule change request, additional commentary on the gamma concept and current arrangements for TNSPs are set out in Appendix A.

1.3 Rationale for the rule change request

The problems raised in the consolidated rule change request are summarised as follows:

- The rules for TNSPs differ from those that apply to electricity distributors and gas networks, where the gamma is not 'locked in'. It is anomalous that the current NER require a known "error" in the proponents' view in relation to gamma to be perpetuated in future transmission revenue determinations until March 2014. The anomaly is exacerbated because it is confined to TNSPs while determinations for other energy networks will be able to adopt the "correct" gamma value.[2]

- Future transmission determinations for TNSPs would otherwise be subject to a gamma value that is known to be erroneous in the view of the proponent.[3] That is, any revision of gamma in the AER's next review of the weighted average cost of capital (WACC) and tax parameters will only apply to revenue proposals submitted after the completion of that review. This means that in the absence of any rule change, a value for gamma of 0.65 must apply to transmission determinations for South Australia (ElectraNet - 1 July 2013 to 30 June 2018), Victoria (SP AusNet - 1 April 2014 to 31 March 2019), and possibly NSW

2 SP AusNet rule change request, 18 November 2011, Attachment 2, p. 1.

3 ElectraNet rule change request, 30 November 2011, p. 6.

(Transgrid - 1 July 2014 to 30 June 2019) and Tasmania (Transend - 1 July 2014 to 30 June 2019).[4]

- A gamma of 0.65, if applied, is inconsistent with the revenue and pricing principles in the NEL which state that a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services. Continuing to apply a value for gamma that is demonstrably too high will lead to an understatement of the cost of corporate income tax in TNSP's revenue allowances and will therefore prevent the recovery of efficient costs.[5]

1.4 Solution proposed in the rule change request

The consolidated rule change request includes proposed rules. To enable SP AusNet and ElectraNet to use the Australian Competition Tribunal (the Tribunal) determined value of gamma in their forthcoming revenue proposals, two separate solutions are proposed (proposed rules):

- SP AusNet proposed an amendment to clause 6A.6.4(f) of the NER and the addition of a new clause 6A.6.4(g) that stated, "if the Tribunal determines that the AER's most recent review of the matters referred to in clause 6A.6.4(d) resulted in an error or errors, and as a consequence of that determination, a different methodology or value is ascribed to the assumed utilisation of imputation credits, the AER must use that different methodology or value for the purposes of clause 6A.6.4(f)".[6]

- On the other hand, ElectraNet proposed that clause 6A.6.4 be updated to deem the value for gamma as it has been determined by the Tribunal, subject to future periodic reviews of WACC and tax parameters. ElectraNet submitted that this simple amendment would maintain the original intent of the rules in respect of the determination of tax and WACC parameters for TNSPs, while providing for correction of the value for gamma. In addition, ElectraNet proposed a one-off transitional rule under Chapter 11 of the rules. This amendment would have the effect of obliging the AER to apply a value for assumed utilisation of imputation credits of 0.25 in determining the estimated cost of corporate income tax referred to in clause 6A.6.4 for the South Australia transmission determination for the regulatory control period commencing 1 July 2013.[7]

1.5 Commencement of rule making process

On 22 March 2012, the Commission published a notice under section 95 of the National Electricity Law (NEL) advising of its intention to commence the rule making process

4 Ibid.

5 Id., p. 5.

6 SP AusNet rule change request, 18 November 2011, Attachment 2, p. 8.

7 ElectraNet rule change request, 30 November 2011, p. 10.

and the first round of consultation in respect of the consolidated rule change request. A consultation paper prepared by Australian Energy Market Commission (AEMC) or Commission staff identifying specific issues or questions for consultation was also published with the rule change request. Submissions closed on 19 April 2012.

The Commission received two submissions on the rule change request as part of the first round of consultation. They are available on the AEMC website.[8]

1.6 Publication of draft rule determination

On 28 June 2012 the Commission published a notice under section 99 of the NEL and a draft rule determination in relation to the rule change request (draft rule determination).

Submissions on the Draft Rule Determination closed on 10 August 2012. The Commission received three submissions on the draft rule determination. They are available on the AEMC website.[9] The issues raised in submissions have been addressed by the Commission in its analysis of the consolidated rule change request in Chapter 4 of this final rule determination.

8 www.aemc.gov.au

9 www.aemc.gov.au

2 Final rule determination

2.1 Commission's determination

In accordance with section 102 of the NEL, the Commission has made this final rule determination in relation to the proposed rules submitted by SP AusNet and ElectraNet. In accordance with section 103 of the NEL the Commission has determined not to make the proposed rules. The Commission's reasons for making this final rule determination are set out in section 2.4.

2.2 Commission's considerations

In assessing the consolidated rule change request the Commission considered:

- the Commission's powers under the NEL to make the rule;
- the rule change request;
- the fact that there is no relevant Ministerial Council on Energy (MCE) Statement of Policy Principles;[10]
- submissions received during the first and second rounds of consultation;
- the Commission's analysis as to the ways in which the proposed Rule will or is likely to, contribute to the achievement of the National Electricity Objective (NEO)
- the revenue and pricing principles under section 7A of the NEL;
- the Commission's draft rule determination on Economic Regulation of Network Service Providers;[11]
- the Commission's November 2008 determination relating to the parameter values, equity beta and gamma rule change request for the Energy Users Association of Australia;[12] and
- the Tribunal May 2011 decision relating to gamma.[13]

10 Under section 33 of the NEL the AEMC must have regard to any relevant MCE statement of policy principles in making a Rule.

11 AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations, 23 August 2012, Sydney.

12 AEMC 2008, *Final rule determination - Parameter values, equity beta and gamma, Final rule determination*, 13 November 2008.

13 Application by Energex Limited (Gamma) (No 5) [2011] ACompT 9 (12 May 2011).

2.3 Commission’s power to make the rule

The Commission is satisfied that the proposed rules fall within the subject matter about which the Commission may make rules. The proposed rules fall within section 34 of the NEL as they relate to sections 34(1)(a)(i), the operation of the national electricity market, and 34 (1)(a)(iii), the activities of persons (including Registered Participants) participating in the national electricity market or involved in the operation of the national electricity system.

Further, the proposed rules fall within the matters set out in schedule 1 to the NEL, as it relates to item 15, regarding the regulation of revenues earned or that may be earned by owners, controllers or operators of transmission systems from the provision by them of services that are the subject of a transmission determination.

2.4 Rule making test

Under section 88(1) of the NEL, the Commission may only make a Rule if it is satisfied that the Rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

> “The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system.”

The consolidated rule change request could potentially affect the ability of, and the efficient operation of, the incentives on SP AusNet and ElectraNet to invest in their network assets for their next regulatory control period. Generally, any change in the level of investment in networks is likely to impact the price, quality, reliability and security of supply of electricity.

The Commission has assessed whether the consolidated rule change request would better balance the need to attract sufficient investment in the networks with the need to ensure that prices for consumers are no more than necessary to provide an appropriate level of service.[14]

The Commission is not satisfied that the proposed rules providing for a revised gamma of 0.25 to apply to the next revenue determination for SP AusNet and ElectraNet will, or are likely to, contribute to the achievement of the NEO because:

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14 Under section 88(2), for the purposes of section 88(1) the AEMC may give such weight to any aspect of the NEO as it considers appropriate in all the circumstances, having regard to any relevant MCE Statement of Policy Principles.

- the consolidated rule change request effectively requires the AEMC to review a decision of the AER. It is neither appropriate nor efficient for the AEMC to conduct a review of the appropriate value of gamma, any other parameter of a rate of return estimate, or the overall rate of return. This role is more appropriately carried out by the AER as the economic regulator.

- the framework for calculating the rate of return for transmission businesses is codified in current chapter 6A of the NER. The chapter 6A framework requires that all elements of the rate of return (including gamma) be considered as part of a single periodic review to allow an estimate of an appropriate overall rate of return to be made. The rate of return is set for five years. Permitting gamma or any other rate of return parameter to be amended outside of that framework would undermine the integrity of the current rate of return framework and create regulatory uncertainty, thereby resulting in an increase in the regulatory risks faced by network businesses.

- varying the value of gamma as proposed by SP AusNet and ElectraNet in the absence of analysing its impact on the overall rate of return may result in an underlying change in the incentive arrangements for these network businesses that may not be in the long-term interests of consumers.[15] Without considering the other rate of return parameters, there is risk of over-recovery of costs to the detriment of consumers and the Commission could not conclude with any certainty that the overall rate of return would be improved.

The role of the AEMC is to assess and amend the frameworks applicable to market participants under the NER which, for the rate of return framework under chapter 6A of the NER, is currently being undertaken through the rule change requests initiated by the AER.

The problem identified in the consolidated rule change request does not seek to amend these frameworks, but to substitute a single outcome of a review by the AER. The AEMC considers that substitution of a single AER decision is as outlined above inconsistent with the NEO and undermines the overall rate of return framework that applies in Chapter 6A of the NER.

In their rule change requests both SP AusNet and ElectraNet stated that not making their proposed rules would prevent recovery of efficient costs and may create incentives for inefficient deferral of investment. This point was also made by SP AusNet in its submission on the draft rule determination.

15 For instance, there is a well-recognised conceptual relationship between gamma and the market risk premium (MRP) in estimating the total return that would be required for investment in equity capital under a dividend imputation tax system. Estimating the MRP using market data will generally only reflect the return equity investors expect from dividend pay-outs and capital gains. Therefore, assumptions about how the MRP is measured plays a critical role when estimating gamma to recognise the value of dividend imputation franking credits, and vice versa.

These statements have not been supported by any evidence that not amending gamma in the way that they have requested would result in an overall rate of return that would prevent recovery of efficient costs, or create investment distortions.

2.5 Other requirements under the NEL

In applying the rule making test in section 88 of the NEL, the Commission has taken into account the revenue and pricing principles as required under section 88B of the NEL. The revenue and pricing principles are set out in section 7A of the NEL. The consolidated rule change request relates to the principles of providing a reasonable opportunity to recover efficient costs in providing network services and complying with requirements and obligations and effective incentives to promote efficiency in respect to the network services provided by a network service provider.

As stated above, SP AusNet and ElectraNet submitted that not amending gamma would prevent these network businesses from having the opportunity to recover their efficient costs. However, the proponents do not provide evidence identifying how the overall rate of return would result in them not being able to recover their efficient costs when the current value of gamma (0.65) is applied.

Amending gamma in isolation, without an assessment of any potential impacts on the overall rate of return estimate may not achieve any greater certainty that the principles of providing network businesses with the effective incentives required to promote economic efficiency is likely to be achieved.

3 Commission's assessment approach

This chapter describes the analytical framework that the Commission has applied to assess the consolidated rule change request in accordance with the requirements set out in the NEL (and explained in Chapter 2).

The Commission has assessed the consolidated rule change request on a transitional basis. That is, the Commission has considered whether a revised gamma of 0.25 should be applied to the next revenue determinations for SP AusNet and ElectraNet. The Commission has not considered the broader issue of the Tribunal decisions on the rate of return estimate, as this is being considered as part of the AER's network regulation rule change requests.

In assessing any rule change request, the Commission must have regard to the extent to which the rule will, or is likely to, contribute to the achievement of the NEO. In making this assessment, weight may be given to any specific aspect of the NEO as appropriate.

The consolidated rule change request could potentially affect the ability of, and the efficient operation of, the incentives on SP AusNet and ElectraNet to invest in their network assets for their next regulatory control period. Generally, any change in the level of investment in networks is likely to impact the price, quality, reliability and security of supply of electricity.

The Commission has assessed whether the consolidated rule change request would better balance the need to attract sufficient investment in the networks with the need to ensure that prices for consumers are no more than necessary to provide an appropriate level of service.

In assessing the consolidated rule change request the following issues have been considered:

- recovery of efficient costs – Would a revised gamma for distribution network services providers automatically be the appropriate gamma value for TNSPs? Would a revised gamma applying to SP AusNet and ElectraNet ensure that they are able to fully recover an efficient level of costs to encourage efficient investment in, and operation of, transmission networks for their next revenue determinations? Would a revised gamma lead to customers paying no more than necessary to receive a reliable service?

- investment incentives – Would amending gamma for their next revenue determinations provide SP AusNet and ElectraNet with the required incentives necessary to undertake efficient investment in transmission networks?

- regulatory certainty and transparency – Would a rule permitting the gamma to be revised for SP AusNet and ElectraNet's next revenue determination provide an appropriate amount of regulatory certainty and transparency to reduce ambiguity in the suitable value of gamma to apply? What impacts would this have on the current arrangements for other TNSPs?

- the role of the AER – Is it appropriate for a rule change by the AEMC to amend the value of gamma or is any decision about the overall rate of return, or a parameter within the rate of return estimate most appropriately made by the AER as the economic regulator?

The proposed rules have been assessed against the relevant counterfactual arrangements, which in this case are the current provisions relating to gamma under the NER.

4 Amending gamma

This chapter sets out the Commission's assessment of the consolidated rule change request on a transitional basis. It assesses the issues raised in the consolidated rule change request and submissions in respect of the ability for transmission network service providers to recover their efficient costs and incentivise investment decisions, and the regulatory certainty and transparency provided by the current rate of return framework.

4.1 SP AusNet and ElectraNet's view

SP AusNet stated that following appeals by electricity distributors ETSA Utilities, Energex and Ergon Energy, the Tribunal found that the value of gamma determined by the AER reflected a number of errors in terms of approach and logic. For this reason, SP AusNet considered that the Tribunal decision rendered clause 6A.6.4 anomalous because that clause required, in SP AusNet's opinion, the AER to continue to apply an erroneous value of gamma to future transmission revenue determinations.[16]

Similarly, ElectraNet stated its rule change request is intended to "amend clause 6A.6.4 of the NER to incorporate the value for gamma determined by the Tribunal and to add a corresponding transitional provision for the forthcoming revenue reset for South Australia".[17] ElectraNet considered that its proposed NER amendment would provide transmission businesses with the same flexibility afforded other energy networks that are able to adopt the new value of gamma, as it is not locked-in under the NER.[18]

Both SP AusNet and ElectraNet considered that their rule change requests would not apply retrospectively, only applying to future transmission revenue determinations, where the revenue proposal is submitted prior to the completion of the AER's 2014 review of the WACC and tax parameters.

4.2 Stakeholder views

4.2.1 First round of consultation - consultation paper

The Major Energy Users noted that "the development of the WACC parameters in 2009 reflected a balance of competing elements and therefore to change one parameter in isolation of an assessment of all other parameters has the potential to upset the balance between the competing elements".[19] In its submission, the AER agreed with the Major Energy Users' comments noting that "the Chapter 6A framework is operating as

16 SP AusNet rule change request, 18 November 2011, p. 1.

17 ElectraNet rule change request, 30 November 2011, p. 6.

18 Id., p. 1.

19 Major Energy Users submission on the consultation paper, April 2012, p. 2.

intended in that all parameters are to be considered as part of a single WACC review".[20]

In relation to assessing the consolidated rule change request on a transitional basis, the AER noted that "departing from the previous WACC review in respect of one discrete parameter does not provide any greater certainty that the objective of promoting investment in, and efficient use of, electricity services for the long term interests of consumers will be achieved".[21] In its submission, the Major Energy Users agreed with the AER stating that it would be "neither equitable, nor in the interests of consumers for action to be taken on one element of the WACC while not investigating the other elements".[22]

The Major Energy Users were also of the view that "until there has been a decision on how and when WACC parameters are to be assessed, there should be no change to the current rules".[23]

The AER also noted that it had "submitted a rule change to the AEMC that would increase the flexibility for the initiation of a periodic WACC review and the statutory review of the Limited Merits Review framework has been brought forward". The AER considered that, together, "these reviews are capable of addressing the issues raised by the rule change proponents for future regulatory decisions".[24]

The Major Energy Users considered that "if the current wide review of the network regulation rules changes the way the WACC parameters are set, then the new approach should apply immediately and not wait for the WACC parameter determination set for March 2014".[25]

On another note, the Major Energy Users were concerned that SP AusNet and ElectraNet appeared to suggest that "a Tribunal decision should be considered to have a higher standing than other decisions of the AER".[26] As it is the job of the Tribunal to "stand in the shoes of the regulator when reviewing AER decisions and the AER acts as a model litigant working with the Tribunal to identify the correct answer, a Tribunal decision does not possess a higher standing than those of the AER and should not be automatically used to change the NER".[27]

20 Australian Energy Regulator submission on the consultation paper, April 2012, p. 1.

21 Id., p. 2.

22 Major Energy Users submission on the consultation paper, April 2012, p. 2.

23 Ibid.

24 Australian Energy Regulator submission on the consultation paper, April 2012, p. 1.

25 Major Energy Users submission on the consultation paper, April 2012, p. 3.

26 Id., p. 2.

27 Ibid.

4.2.2 Second round of consultation - draft rule determination

The Major Energy Users agreed with "the salient points made by the AEMC in its draft decision and the conclusions that it reached from these".[28] However, the Major Energy Users did not completely agree with the AEMC's assessment of the NEO. That is, the Major Energy users considered that the "rule change request would have negatively impacted on the welfare of consumers, but without any compensating benefit".[29]

The AER agreed with the AEMC's position that "all WACC variables need to be assessed at one time and that assessing a single variable without considering the effect on the other WACC variables would not contribute to the achievement of the NEO".[30] The AER also noted that currently, the "*Economic Regulation of Network Service Providers* rule change is considering the rules under which gamma and other parameters are determined and the ability for the AER to initiate a periodic WACC review".[31]

On the other hand, SP AusNet did not agree with the draft rule determination not to make a draft rule. Specifically, SP AusNet did not agree with the AEMC's rationale for not making a draft rule based on its assessment of regulatory certainty and transparency. SP AusNet considered that the objective of certainty should not outweigh all other considerations, including the objective of seeking to achieve the revenue and pricing principles.[32] That is, providing TNSPs with a reasonable opportunity to recover the efficient costs incurred by that service provider in providing regulated services, and providing TNSPs with effective incentives to promote efficient investment.

SP AusNet also noted that the value of gamma (0.25) determined by the Tribunal in relation to Energex "was not made in isolation, but rather was made by the Tribunal having regard to potential inter-relationships with other rate of return parameters".[33] Submissions on the issue of the inter-relationship between gamma and the market risk premium were sought by the Tribunal from the AER with the Tribunal ultimately determining that no consequential adjustment to the market risk premium was required.[34]

In relation to the appropriateness of the AEMC making adjustments to gamma, SP AusNet stated that its rule change request was only to allow for a one-off adjustment to the value of gamma to update it in line with the Tribunal's review. SP AusNet noted that it was not requesting the AEMC to undertake an independent review of the gamma parameter, as this review has already been conducted by the Tribunal in conjunction with the AER. Furthermore, the "outcome of this review has been accepted

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28 Major Energy Users submission on the draft rule determination, August 2012, p. 1.

29 Id., p. 2.

30 AER submission on the draft rule determination, August 2012, p. 1.

31 Ibid.

32 SP AusNet submission on the draft rule determination, August 2012, p. 2.

33 Id. p. 3.

34 Id. p. 4.

by the AER, and adopted in recent determinations under the National Gas Rules and Chapter 6 of the NER".[35]

4.3 Analysis and conclusion

4.3.1 Recovery of efficient costs and investment incentives

Applicability of Tribunal determined revised gamma to transmission businesses

SP AusNet and ElectraNet stated in their rule change requests that the Tribunal determined a revised value of gamma for a number of distribution businesses and this revised value should automatically be applied to transmission businesses to avoid distorting incentives for efficient investment and to be consistent with the revenue and pricing principles, especially recovery of efficient costs.

The AER and the Major Energy Users considered it was not appropriate to consider one rate of return or WACC element in isolation. That is, the Major Energy Users and the AER indicated in their submissions that a change to one element in isolation of an assessment of all other elements has the potential to upset the balance between competing elements and is unlikely to satisfy the objective of promoting investment in, and efficient use of, electricity services for the long term interests of consumers. The AER also stated that "even if it were accepted that the appropriate gamma value is 0.25, the AEMC can have no confidence that the quality of the overall rate of return estimate is improved by this rule change request".

As outlined in the draft rule determination, without a more detailed review there is a risk that amending gamma in isolation would enable these TNSPs to recover a larger allowed revenue from network users, which may not be in the long term interests of consumers as they would be required to pay more for no change in the overall level of service. Therefore, the Commission reiterates that it is not appropriate to allow a once-off adjustment to the value for gamma outside of an overall review of the rate of return estimate to update it in line with the Tribunal's merits review decision.

In its submission on the draft rule determination, SP AusNet referred to the AER applying the revised gamma as part of other decisions. The AEMC acknowledges this, but notes that in those contexts the AER was able to consider other rate of return elements as part of its overall decision. Amending gamma in the context of the consolidated rule change request would be different and require a more detailed review, more appropriately undertaken by the AER.

SP AusNet also stated in its second round submission that the issue of the inter-relationship between gamma and the market risk premium was investigated as

35 Ibid.

part of the Tribunal decision, with the Tribunal ultimately determining that no consequential adjustment to the market risk premium was required.[36]

Evidence of the regulator responding to changing financial market conditions may be found in recent electricity distribution and gas determinations. For example, the recent distribution determination for Aurora Energy and gas access arrangement for Envestra in South Australia have as indicated by SP AusNet incorporated the Tribunal amended gamma of 0.25. However, in response to changes in the financial market following the global financial crisis these recent decisions also contain an amended market risk premium. The market risk premium in both of these decisions was reduced from 6.5 per cent to 6.0 per cent.[37]

Both of the examples cited by SP AusNet refer to decisions undertaken by the AER under Chapter 6 of the NEL and the gas access arrangements under the National Gas Law. It should be noted that the current gas and Chapter 6 frameworks provide for greater flexibility in the rate of return provisions in a way that the transmission framework under Chapter 6A does not.

SP AusNet commented that the AER has "made no amendment to any other parameter consequential on the adoption of a value for gamma of 0.25, in circumstances where it clearly has the power to do so".[38] Yet, in recent decisions, both Aurora Energy and Envestra received a lower market risk premium (among other elements) as part of their overall rate of return.

Notwithstanding, as chapter 6A of the rules "hard-wires" some of the relevant rate of return variables for TNSPs, SP AusNet would be granted the higher market risk premium of 6.5 per cent rather than that currently utilised by the AER.

Therefore, should the Commission make a rule that amended the value of gamma in isolation of any consequential assessment of the resultant overall rate of return, SP AusNet and ElectraNet may be granted a rate of return that is unlikely to reflect current financial market conditions.

Supporting evidence

In its second round submission, SP AusNet again referred to recovery of efficient costs stating that amending gamma would enable "TNSPs a reasonable opportunity to recover at least their efficient costs where the rate of return framework is sufficiently flexible to adapt to changing market conditions and developments in finance theory".[39]

SP AusNet and ElectraNet submitted that the incentives for efficient investment will be distorted in circumstances where the value of gamma is knowingly set too low. In

36 Id., p. 3.

37 AER, Distribution determination for Aurora Energy 2012-13 to 2016-17, Overview, p. 29 and Envestra, Access arrangement proposal for the SA gas network, p. 36.

38 SP AusNet submission on the draft rule determination, August 2012, pp. 3-4.

39 SP AusNet submission on the draft rule determination, August 2012, p. 2.

particular, such an outcome provides a strong incentive for a transmission business to defer capital expenditure to a later period when the value of gamma will be corrected. Notwithstanding, no evidence was provided that the rate of return that would apply to these transmission service providers in the absence of a change to gamma would result in avoided investment.

A similar point was made about recovery of efficient costs in SP AusNet's and ElectraNet's rule change request. SP AusNet reiterated this point in its second round submission. Without considering other elements and other data available, it is difficult to ascertain whether this is the case. Indeed it is the overall rate of return that establishes incentives for efficient investment and provides for the recovery of efficient costs. Thus the task of determining whether investment incentives have been distorted and recovery of efficient costs has been compromised for these TNSPs is more appropriately that of the AER. This is consistent with that of the AER being responsible for consideration of the rate of return framework as a whole.

As stated above, no evidence has been provided to support these statements as part of this rule change request.

In summary, as stated in the draft rule determination, varying the value of gamma as proposed by SP AusNet and ElectraNet in the absence of analysing any impacts on the overall rate of return may result in an underlying change in the incentive arrangements for these network businesses. This raises the risk of over recovery of costs to the detriment of end consumers of electricity.

4.3.2 Regulatory certainty and transparency

The current framework for determining the rate of return for transmission network businesses as part of their revenue determinations is contained under chapter 6A of the NER. At the time of codifying Chapter 6A in the NER, the Commission considered it necessary to enable the AER to review the methodology and parameters periodically and have the flexibility and discretion to take into account changes in financial market conditions and developments in finance theory and practice. It was for this reason that the final rule gave the “AER the discretion to vary the WACC methodology or parameters at subsequent five-yearly reviews following the consultation process under the NER”.[40]

TNSP submissions at the time were generally supportive of the Commission’s approach of codifying the WACC parameters in the NER and providing for a review of all of the parameters every five years, as it provided greater certainty to industry participants, thereby providing a more stable investment environment.[41]

The AEMC is currently assessing rule change requests from the AER and a group of large energy users (EURCC) relating to the rate of return frameworks. In the draft rule

40 AEMC 2006, National Electricity Amendment (Economic Regulation of Transmission Services) Rule No. 18 2006, Rule determination, 16 November 2006, Sydney, p. 82.

41 Id., p. 83.

determination for these rule change requests the AEMC has acknowledged that the rate of return framework applying to TNSPs does not provide sufficient flexibility to adapt to changing circumstances.[42]

As an alternative, the AEMC has proposed a common approach (electricity distribution, electricity transmission and gas) that would require the regulator to make an estimate of the rate of return that is consistent with an overall objective. The objective is 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. Under this approach the regulator would have the flexibility to adopt the approach it considers appropriate so that the best estimate of the rate of return can be made at the time of the determination is made.

In this way, the regulator can better respond to "changing financial market conditions, particularly where volatile market conditions impact on a service provider's ability to attract sufficient capital to finance the expenditure necessary to provide a reliable energy supply to consumers".[43]

Also, under the proposal, NSPs can request alternatives to estimating the rate of return as part of their regulatory/revenue proposals. In both the case of the AER and NSPs the focus of the new approach is on the overall rate of return meeting an objective. That is, if a single element of the rate of return is to be changed, a case first needs to be made that the change would result in an overall better outcome.

In this way the proposed approach to estimating the rate of return is still consistent with the current approach for electricity transmission that seeks to look at all elements that make up the rate of return as a whole. The proposed approach is inconsistent with that set out in the consolidated rule change request.

Despite the proposed amendments to the framework for chapter 6A outlined above, as summarised in the draft rule determination having a rate of return framework, regardless of its form, provides a level of regulatory certainty and transparency. All stakeholders can anticipate the outcomes of the regulatory process with an understanding of how key elements, such as the rate of return, are to be determined - whether the rate of return is set in advance as part of a periodic review, or determined on a case by case basis as part of each individual determination process.

That is, as stated in the draft rule determination, the certainty and transparency provided by the framework established in the NER and applied by the AER would be compromised if rule changes were made to amend elements of the application of those frameworks in isolation.

The AEMC also considers that the AER, as economic regulator, is the most appropriate body to make decisions on the rate of return and individual parameters within a rate of

42 AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft rule determinations, 23 August 2012, Sydney, pp. 32-33.

43 Ibid.

return. The AEMC's role is to make rules that provide a framework within which such estimates may be made by the AER.

As ElectraNet is currently progressing with the AER its forthcoming revenue determination, its rate of return is being made under the existing rules outlined in chapter 6A of the NER.

SP AusNet is yet to start the revenue determination process for its next regulatory control period. Transitional arrangements for the economic regulation of network service providers rule change request were published for consultation on 13 September 2012. They provide for the current rate of return provisions to apply to SP AusNet for a one year period commencing 1 April 2014. After this time, the proposed rate of return provisions in the draft rule determination would apply.

4.3.3 Conclusion

As stated above, the consolidated rule change request has been assessed on a transitional basis. That is, whether the Commission should make a rule that permits gamma to be amended from the current 2009 review of the WACC and tax parameters undertaken by the AER. This proposed rule would amend the value of gamma from 0.65 to 0.25; however, all other elements of the rate of return framework would remain unchanged.

Consideration of the proposition within the consolidated rule change request from the perspective of recovery of efficient costs, investment incentives, regulatory certainty, and the appropriate role of the AER, a rule that would amend one element of the rate of return framework in isolation, without considering other elements should not be made.

SP AusNet has argued that the AEMC has incorrectly valued regulatory certainty over efficient investment and recovery of efficient costs.

The arguments put forward by SP AusNet and ElectraNet that if the rule is not made it would distort investment incentives and be inconsistent with the revenue and pricing principles have not been supported with evidence from these TNSPs.

A Background information

A.1 Gamma

In chapter 6A of the NER, the weighted average costs of capital (WACC) is an estimate of the fair rate of return on capital that investors (including both debt and equity holders) in the benchmark firm might reasonably expect as having their capital at risk.

Under chapter 6A, the Australian Energy Regulator (AER) must conduct a review of the WACC parameters every five years. For some parameters, the specific values adopted in that review cannot be departed from in determinations over the subsequent five year period. These parameters include equity beta, market risk premium, gearing, credit rating, and gamma; the last of which is the subject of this rule change request. The last review was carried out in 2009 and the next is scheduled for 2014. The parameters from the last review will apply to the forthcoming revenue determinations for SP AusNet and ElectraNet.

The estimated cost of corporate income tax is usually considered in conjunction with WACC parameters. It is important because the investors' return on capital must be calculated after allowing for corporate tax. For this reason, the estimated cost of corporate income tax is added to a TNSP's revenue requirements.

Gamma is relevant to the estimated cost of corporate income tax. It represents the value of imputation credits and has an effect on the "grossing up" of a TNSP's revenue requirements for corporate income tax.

Where the value of imputation credits or gamma is higher, the estimate of corporate income tax that is added to a TNSP's revenue requirement will be lower because individual investors can offset more of their individual tax liability with the imputation credits. Where the value of imputation credits is lower, the estimate of corporate income tax that is added to a TNSP's revenue requirement will be higher as investors will require a higher return to cover their tax liability from income earned from their investment in that TNSP.

In summary, the value of gamma has the following impact on the building block revenue and prices:

- a decrease in gamma increases the building block revenue and prices; and
- an increase in gamma decreases the building block revenue and prices.

A.2 Merits review

Under chapter 6 of the NER, the AER can consider persuasive evidence from distribution network service providers (DNSPs) to depart from the outcomes of the periodic WACC review. This decision is also subject to merits review.

The value of gamma has been subject to merits review by a number of DNSPs, namely ENERGEX, Ergon Energy and ETSA Utilities. As a result of that merits review in the electricity distribution context, the Australian Competition Tribunal (the Tribunal) determined that the correct value of gamma for electricity distribution network service providers is 0.25, as opposed to 0.65 (the value also determined by the AER in its 2009 WACC review for TNSPs).

Since the merits review of gamma, the AER has adopted the revised value of 0.25 in electricity distribution (and gas). The NER do not, however, permit the AER to consider applying the revised gamma to any TNSP revenue determination until the next scheduled review of the rate of return parameters (scheduled for 2014). Clause 6A.6.4(f) provides:

> "If, as a consequence of a review, the AER decides to adopt a revised value or methodology, it must use that revised value or methodology, but only for the purposes of a Revenue Proposal that is submitted to the AER under clause 6A.10.1(a) after completion of the first review or after completion of the five yearly reviews (as the case may be)."

This means that even if the AER considers that the gamma value determined by the Tribunal in the context of DNSPs is the correct value that should be applied for all network service providers, the AER must continue to apply the gamma value that it fixed in its 2009 review for electricity transmission.

Abbreviations

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
Commission	See AEMC
EURCC	energy users rule change committee
DNSPs	distribution network service providers
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
NSP	network service provider
rules	see NER
the Tribunal	Australian Competition Tribunal
TNSPs	transmission network service providers
WACC	weighted average cost of capital