Economic Regulation of Networks Rule Change Requests Workshops – 2 April 2012 – Park Royal Hotel, Melbourne Airport

The summary below has been prepared by AEMC staff. It does not represent the views of the AEMC or the views of the participants that reported to the plenary session. The summary captures generally the matters discussed at the workshops and does not represent a consensus view of participants at the workshops.

Summary of participant presentations – plenary session

Capital expenditure (capex) and operating expenditure (opex) allowances – workshops 1 and 5

Rainer Korte from Electranet provided a summary of the discussion from workshop 1. He reported that there were five areas of general agreement:

- Network service providers (NSPs) should have an incentive to put forward robust proposals.
- It is not the role of the Australian Energy Regulator (AER) to second guess NSPs, but the AER should have the discretion to challenge NSP's proposals, using a range of techniques including benchmarking.
- If the conclusion is that the NSP's forecasts are not consistent with the rules, then the AER should have the discretion to substitute the forecasts.
- There should be an evidence-based approach to substituting forecasts, so that there are no surprises.
- Greater customer engagement is needed.

Rainer also reported on three areas where there was no agreement:

- The extent to which the first five items discussed above actually take place and occur currently.
- How, under the AER's proposed rules, would things be different?
- The extent to which the current rules are contributing to high electricity prices.

Finally, Rainer commented that the AER considers it has discretion to reject forecasts but the AER does not see that it has the same discretion to substitute its own. There are some limitations with the two stage process – possibly also contributed to by how the rules are interpreted and corporate governance processes of the NSPs. The AER should make available material changes between its draft and final decisions.

Garth Crawford from Energy Networks Association provided a summary of the discussion from workshop 5. He reported that the following issues were discussed in this workshop:

- The AER stated that it was concerned about the two stage process. The AER suggested having only a one stage process.
- There was discussion on whether there is any material difference between the two stage process and a one stage process. Also there was doubt on whether this is a procedural constraint.

- There was discussion on whether the AER should assess capex and opex allowances on a category by category basis or whole of capex/opex allowances in total.
- Generally, there were no major concerns regarding the evidentiary burden.
- The role of benchmarking is not clear in the rule. Removal of individual circumstances would be a problem.
- There should be some process for new information with respect to draft and final determinations.

Capital expenditure (capex) incentives and related issues – workshops 2 and 6

Tom Hallam from SP Ausnet provided a summary of the discussion in workshop 2. He noted that the current arrangements came from concern around ensuring reliability in the face of rapidly escalating maximum demand. There was also an acknowledgement that risks of over and under investment are not symmetrical. But now increasing prices are of concern.

Tom noted that there was broad agreement in the workshop that the current regime has some flaws. Consumers/governments and the AER are concerned that consumers do not pay more than is needed or justified. Two broad solutions were identified:

1 improve the incentive regime, or
2 close the supervision gap through ex-post review.

Tom also reported on the following discussions from this workshop:

- Consumers highlighted that the rate of return also places incentives on NSPs capital expenditure.
- There was some interest in the use of ex-post reviews. Ex-post reviews close the supervision gap but can create significant extra burden on the AER and NSPs. NSPs consider this a second best solution and prefer incentive mechanisms. NSPs think that ex-post reviews along with some form of pre-approval of capex could work.
- Any capex incentive mechanism has to interact with strong opex and service standards incentives. It is not clear that the AER's proposed 60/40 sharing mechanism addresses the problems identified.
- Other incentive schemes – the AER wants discretion to introduce incentives and refine over time. NSPs prefer a rule process where the assessment of any new incentive scheme is made against transparent criteria. Otherwise guidance needs to be put in the National Electricity Rules (NER).
- Uncertainty regime – difficult to apply capital expenditure reopeners and contingent projects to distribution, particularly in current form. Maybe have a regime that addresses programs rather than projects for distribution.
- The impact of changes to prices during the regulatory control period impacts on retailers' abilities to set their pricing structures.
- Actual or forecast depreciation – the AER wants full discretion to decide on the method of depreciation for establishing a NSP's opening regulatory asset base. The group asked whether the NER were too inflexible and should allow for different depreciation treatment depending on the type of asset.
- Related party margins – most participants agree that this is an issue. The AER and governments want to close a loophole in the NER. The AER conceded that reviewing the method of calculating related party margins rather than the dollar amount is more appropriate. NSPs stated that the NER should not cause NSPs to rule out particular business arrangements that might be the most efficient.

Bob Lim, consultant representing Major Energy Users Inc provided a summary of the discussion from workshop 6. He noted that the following points made in this workshop:

- NSPs may overspend for good reason. The counterfactual is that they overspend for profits due to differences between their allowed and true costs of capital. The privately owned NSPs said they would simply not over spend.
- Deferral of capex within period is not necessarily a bad thing.
- The approach adopted by the Energy Regulation Authority in Western Australia of pre-approving capex overspends should be considered by the AEMC.
- The group came to a conclusion that capex allowances should be set in concrete for the regulatory control period and should only be reviewed during the course of a regulatory control period if something material happens.

Rate of return frameworks – workshops 3 and 7

Brian Carrick from Queensland Treasury Corporation provided a summary of discussion from workshop 3. On the discussion on framework issues, he reported on:

- The discussion on AEMC's assessment of the existing frameworks, noting that participants provided broad support for the Chapter 6A and gas framework assessments. He also identified issues that were discussed around the characterisation of problems with Chapter 6 of the NER;
- The discussion on interrelationship and interdependencies of the weighted average cost of capital (WACC) parameters and the differences in how these might differ in application by the AER and the Australian Competition Tribunal (Tribunal).
- The discussion on the attributes of a good rate of return framework, noting that investment certainty was highlighted by participants as a key attribute.
- Limited agreement on which model to base a common framework, particularly whether a case had been made to have different frameworks for electricity and gas.

On the discussion on cost of debt issues, Brian noted that the following points were made in workshop 3:

- The discussion on important developments in Tribunal decisions and the AER's approach since the rule change requests were made.
- The views of NSPs that the benchmark should still be based on a 10 year corporate bond.
- The issues raised around the regulatory design questions of an incentive-based framework if a trailing average approach was implemented.

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- The issues raised around the regulatory design questions of an incentive-based framework if a trailing average approach was implemented.

Anthony Cribb from DBNGP (WA) Transmission provided a summary of discussion from workshop 7. On the discussion on framework issues, he noted the similarities of issues and views as reported from workshop 3. He noted:

- The participants' general agreement on AEMC's assessments of Chapter 6A and the gas frameworks.
- The views from NSPs that the persuasive evidence test should be retained.

- The views from consumers and energy users that WACC outcomes should be compared to market realities.
- The need to include consideration of investment certainty and consumer engagement in the rate of return framework.

On the cost of debt discussion, Anthony reported that:

- There was some disagreement on what the benchmark should be for the debt risk premium (DRP).
- There was broad, but cautious, support for the use of a trailing average approach to cost of debt, but that this should be limited to DRP and not the risk free rate.
- There were issues around transitioning to a new DRP approach in terms of refinancing risk.
- Consumer groups and energy users were against AEMC's reasons for rejecting the EURCC's proposal on determining the cost of debt for government-owned NSPs differently to privately-owned NSPs.

Regulatory process issues – workshops 4 and 8

Tony Westmore from Australian Council of Social Service provided a summary of the outcomes of workshop 4. He reported:

- There was general agreement that delaying the making of the final regulatory determination would affect all parties.
- There was consensus that the regulatory determination process should commence earlier by at least three months.
- Consumers should be engaged earlier by NSPs.
- The inclusion of a mandatory issues paper would allow for more effective engagement. The paper would be a distillation of the AER's views of the key issues arising from the NSP's regulatory proposal.
- More consultation should occur prior to the AER making the final regulatory determination.

Tony also noted that:

- There were different views as to whether the framework and approach paper should be retained. It has been proposed that the paper could also consider in advance the method that Distribution Network Service Providers use to forecast capex and opex.
- General consensus on the stop the clock mechanism to be used to extend the time for assessing complex matters related to applications on cost pass throughs, capex reopeners and contingent projects.
- Resolving material errors in final regulatory determinations would be better done outside of the merits review process. The AER considered at times that it was constrained in addressing material errors either because the merits review process had already commenced or the narrow scope under Chapter 6 would not allow the AER to consider other errors. However, general consensus was that more evidence was required to support a change to the current scope of material errors in the rules.
- NSPs consider that they have provided non-confidential material to the AER which should have been published, but was not published by the AER. The AER could ask the NSP to advise on whether they consider certain information to be confidential.

Don Woodrow from Powerlink Queensland reported on the outcomes of workshop 8. He reported:

- Consensus that the timeframe for the regulatory determination process needs to be revised due to the volume of information being considered by the AER and stakeholders.

- General agreement that delaying the making of the final regulatory determination is not a desirable option. For example, this option would have a negative impact on the annual pricing proposal process.
- Commencing the process earlier is advantageous and would allow the NSPs to prepare their revised regulatory proposal, and for an additional consultation stage such as cross-submissions.
- If an issues paper was prepared, more time needs to be provided in the regulatory determination process. The issues paper would provide a “map” of the regulatory proposal to assist consumers.
- Consumer groups are concerned they are being provided with too much information to consider in the regulatory determination process.

Don also noted that:

- The AER has had time constraints in considering confidential information. NSPs propose to develop a protocol for addressing confidential information, which may be similar to the approach taken by the regulator in the telecoms industry. This would also avoid using the rules as a vehicle to address confidentiality claims related to regulatory proposals. The confidential information could be categorised according to the degree of commercial harm.
- The NSP’s proposed method for forecasting capex was proposed to be included in the framework and approach paper. Some suggest this will improve transparency in the regulatory determination process.