Government of **Western Australia**
Department of **Finance**
Public Utilities Office

Your ref :
Our ref : 2012/01071
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Mr John Pierce
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
SYDNEY NSW 2000

Dear Mr Pierce

ERC0134 - SUBMISSION ON AEMC'S DIRECTIONS PAPER

The Public Utilities Office (Office) welcomes the opportunity to provide comment on the Australian Energy Market Commission's (AEMC) Directions Paper on the Economic Regulation of Network Service Providers Rule Change Request.

The Office maintains its position that it does not support the Australian Energy Regulator's (AER) proposed amendments to the National Gas Rules (NGR) outlined in the Economic Regulation of Network Service Providers Rule Change Request.

The Office considers that the AER has not made a convincing case that the current rate of return framework in the NGR needs to be changed on the basis that it does not meet the National Gas Objective (NGO).

The requirements for determining the return on capital allowance is largely a replication of the predecessor provisions from the *National Third Party Access Code for Natural Gas Pipeline Systems* (the National Gas Code).

The Office points to the Standing Committee of Officials (SCO) which saw no reason to depart from the National Gas Code provisions in the formation of the new gas regime: "the initial NGR will largely replicate the wording of the current Gas Code test, which has proved to be adequate."[1]

The Office notes that the new gas regime has only been in operation since 2008 and only about half the gas service providers have had experience under the current framework. Accordingly, it seems somewhat premature to fundamentally change the NGR rate of return provisions.

[1] "SCO Response to Issues Raised in Submissions on the National Gas Rules" p10; 14 May 2007.

The Office notes that the AER proposes that the three frameworks (electricity distribution, electricity transmission, and gas) move to a single rate of return approach which most closely aligns to electricity transmission, in which there are periodic (five yearly) reviews of the rate of return parameters which are then fixed for each electricity or gas service provider.

The Office considers that the electricity transmission framework is problematic on a number of fronts. Firstly, the electricity transmission framework prohibits the identification of the true weighted average cost of capital (WACC) parameters since they are unable to be reassessed at each individual determination. This is reinforced by advice provided by the AER's consultant, Stephen Lloyd, on this matter: "... it may be argued that, as this mechanism (like the existing regime for TNSPs) will not allow WACC parameters to be re-assessed in every individual determination, it provides less capacity to identify the "true" WACC parameters at the time of each determination thereby diminishing the capacity to achieve the NEO/NGO."[2]

A case in point is that in the merits review appeals sought by electricity distribution network service providers (DNSPs), "the Tribunal has determined that the AER erred in estimating the value of the gamma parameter value in the first electricity distribution determination after the WACC review in 2009".[3] However, the AER cannot consider applying the revised gamma value as determined by the Tribunal to any electricity transmission network service provider's (TNSPs) revenue determination made after the 2009 WACC review until the next scheduled WACC review[4].

Secondly, the electricity transmission framework was developed with the aim of mitigating the under-investment problem[5]. The AER makes the point in its Executive Briefing that "During the development of the rules for electricity transmission networks in 2006, the AEMC considered that the general protections afforded by the Law and the administrative law for regulatory decision-making were not sufficient to guard against the risk of the regulator restricting allowances to levels below efficient cost. Despite submissions at the time challenging this assumption, rules were drafted to lock down the regulatory decision making process to address the perceived risk."[6]

Thirdly, the electricity transmission framework "does not allow for WACC parameter values to be adjusted for any errors that are potentially made when estimating the parameter values at the time of each WACC review."[7] This is of concern especially in light of the fact that "Submissions from NSPs noted that the AER has conceded errors in its estimation of WACC in a number of appeals, and that the Tribunal has found

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[2] Memorandum of Advice, Stephen Lloyd SC, p15; 21 September 2011.
[3] AEMC's Directions paper, p79.
[4] *Ibid.* p79.
[5] Preliminary views for the AEMC, George Yarrow p3;
[6] 'Promoting efficient investment – protecting consumers from paying more than necessary' Executive Briefing Energy network regulation reform, p1.
[7] AEMC's Directions paper, p79.

errors by the AER in determining WACC parameter values in many reviews of WACC decisions brought to date."[8]

Fourthly, the WACC reviews for TNSPs are not subject to merits review under the National Electricity Law (NEL). The Office shares the AEMC's view that "a rate of return framework that does not allow for merits reviews of WACC parameters can create distortions in the rate of return of TNSPs by not allowing adjustments to be made for any errors, incorrect exercise of discretion and unreasonable decisions made by the AER."[9] The Office considers that a rate of return framework without access to merits review of WACC reviews undermines the determination of the best WACC estimate.

Lastly, the AER's proposal that the three frameworks (electricity distribution, electricity transmission, and gas) move to a single rate of return approach which most closely aligns to electricity transmission would not be appropriate for adoption in Western Australia. The Office submits that the reduced administrative burdens anticipated by the AER relate only to the eastern states and submits increased efficiencies will not be reflected in Western Australia as the Economic Regulation Authority (ERA) only administers four gas pipelines, and does not administer any electricity networks under the National Electricity Rules (NER).

The AER has conceded that "... imposing a WACC review and other provisions on the ERA for its gas businesses (noting that the ERA is not subjected to the NER or WACC reviews in the electricity context) would not be justified for the four gas pipelines it regulates."[10]

The Office submits that codification of a nominal post-tax framework restricts regulators and service providers unnecessarily. The Office submits that both pre-tax and post-tax frameworks produce equivalent outcomes (provided the effective company tax rate is accurately calculated) and therefore the only benefit from such an amendment would be to reduce the AER's administration of regulatory decisions.

The Office submits that the ERA has not developed the same consistency as the AER in assessing gas access arrangements on a nominal post-tax model. To codify a nominal post-tax WACC framework would inhibit the ERA's role as an independent regulator in Western Australia.

The Office also points to the fact that both the AER and the ERA supported the NGR not prescribing a pre- or post-tax approach in their joint submission to the Ministerial Council on Energy (MCE) on the draft National Gas Rules.[11]

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[8] *Ibid.*, p84.
[9] *Ibid.*, p80.
[10] AER's rule change proposal - Price and revenue regulation of gas distribution and transmission services AER's proposed changes to the rate of return provisions of the National Gas Rules p15; September 2011.
[11] *Ibid.* p8; September 2011.

The Office holds a strong view that there would be no benefit from amending the NGR in relation to Capital Asset Pricing Model (CAPM) as proposed by the AER. The Office is of the view that the NGR works well in its current form and that codification of the CAPM model is restrictive and could potentially result in further amendments in the future should the CAPM model fall out of favour as the preferred method to calculate the cost of equity.

The Office believes that the AEMC should seek to develop a regulatory environment which best facilitates the determination of a robust WACC estimate. The Office strongly agrees with the following conclusions reached by the AEMC's consultant, SFG Consulting:

- The NEO (National Electricity Objective), NGO and Revenue and Pricing Principles set out in the NEL and National Gas Law require the best possible regulatory estimate of WACC;
- Consideration should be given to allowing regulators the flexibility to adopt the parameter estimates that they believe to be most appropriate for the particular network or pipeline in question rather than being constrained to adopt the same parameter estimates for all regulated firms; and
- Consideration should be given to allowing regulators the flexibility to adopt the parameter estimates that they believe to be most appropriate at the time of each determination.

The Office does not support the Energy Users Rule Change Committee's proposal for different approaches to the cost of debt for government-owned and privately-owned network providers as it could distort decision making regarding any future sale or divestiture of government-owned network service providers.

The Office is concerned that the rate of return framework which the AER is proposing would not be able to cater for the differences in risk profiles across the different sectors. The Office notes that there are considerable differences in risk profiles even amongst the four gas pipelines in Western Australia.

In summary, the Office does not support the proposed changes to the NGR being implemented however, in the event that they are, consideration needs to be given to retaining the national gas regime.

Yours sincerely

Michael Kerr
Acting Deputy Director General, Public Utilities Office

19 April 2012