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14 December 2011

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Sir/Madam

Submission to the Australian Energy Market Commission Consultation Papers – Economic Regulation of Network Service Providers

Essential Energy welcomes the opportunity to respond to the Australian Energy Market Commission (**AEMC**) Consultation Papers on the economic regulation of network service providers in regard to rule change proposals lodged by the Australian Energy Regulator (**AER**) and the Energy Users Rule Change Committee (collectively referred to as the **Rule Change Proposals**).

Essential Energy is a member of the Energy Networks Association (**ENA**). This submission is written in support of the ENA's more detailed and comprehensive response, and should be read in conjunction with that document.

Essential Energy would be pleased to discuss this matter further. Should you require further information or clarification please feel free to contact Natalie Lindsay on 02 6589 8419 or Jason Cooke on 02 6338 3685.

Yours sincerely

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Att. 1.

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Submission to the Australian Energy Market Commission Consultation Papers -

Economic Regulation of Network Service Providers

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1. Background

Essential Energy is a regulated distribution network service provider (**DNSP**), operating an electricity distribution network that extends across an operating area covering 95 per cent of New South Wales' land mass, and into parts of Queensland, Victoria and the Australian Capital Territory. Essential Energy's network includes approximately 200,000 kilometres of powerlines and 1.4 million poles. Within NSW, Essential Energy is licensed to operate its network under the Electricity Supply Act 1995 (NSW).

Importantly, and in providing context to this submission, Essential Energy is yet to experience a regulatory reset under Chapter 6 of the National Electricity Rules (**NER**). Essential Energy, as a NSW DNSP, has been subject to review under transitional Chapter 6 contained in Chapter 11 of the NER only, a determination that applies until 2013-14.

2. Current regulatory framework

The current regulatory framework was established in 2007 to promote certainty, predictability, transparency, accountability and create efficiencies in the operation, maintenance and development of electricity infrastructure. Underpinning the current regulatory regime is a considered approach to the manner and extent of economic regulatory control over a network service provider's network and the management of network assets as a long term investment.

The current regulatory framework was developed in consultation with, and includes significant input by, economic and legal experts and all relevant stakeholders. The Rule Change Proposals contain significant amendments to a framework that was subjected to rigorous analysis prior to its recent introduction. Therefore, Essential Energy's view is that any changes to the current framework would require equivalent justification.

Importantly, the Rule Change Proposals have been initiated prior to the Australian Energy Regulator (**AER**) completing a review of NSW DNSP's under Chapter 6 of the NER. The current regulatory control period commencing from 2009-10 to 2013-14 was assessed under the Savings and Transitional Rules in Chapter 11, and to date, only one year of audited data has been assessed under these transitional provisions. Audited data is yet to be assessed under Chapter 6 of the NER. Essential Energy believes it is too early in this first regulatory cycle under the Chapter 6 rules for the AER to have assessed the adequacy of the current regulatory framework to accurately regulate the capital and operational expenditure of DNSPs.

3. Capital and operating expenditure framework in electricity

The problem

The Rule Change Proposals are premised somewhat on the recent electricity price rises which emanated post the first round of regulatory determinations made under Transitional Chapter 6, Chapters 6 and 6A of the NER. Essential Energy's view is that the perceived flaws identified by the AER in the regulatory framework which allegedly gave rise to the increase in electricity prices are misconceived. Essential Energy acknowledges that electricity prices are increasing.

However, Essential Energy's view is that this is not due to any established flaws in the current regulatory framework, but rather is driven by:

a) the replacement of ageing assets;
b) artificially low and unsustainable levels of historical allowed expenditure and price paths;
c) spatial peak demand growth, that is outstripping what are now decreasing consumption levels;
d) increased funding costs resulting from global economic instability;
e) the introduction of renewable energy schemes; and
f) the associated growth of the regulatory asset base.

Essential Energy's considered opinion is that a history of constrained investment through regulatory determinations has lead to price increases to fund an increased and sustainable level of expenditure. This investment is therefore not a function of the regulatory framework or NER. This point was highlighted by The Honourable Martin Ferguson, Minister for Resources and Energy, in his speech on Strategic Priorities for Energy Market Development when he stated:

> *"Trying to suppress prices ultimately leads to pain in the future when catch-up is required, as some jurisdictions are now finding. Prices reflect the cost of investment to maintain and replace ageing assets to ensure the community gets the reliability it has come to expect."*[1]

Essential Energy believes that a sustained level of investment expenditure will flatten out peaks and troughs in pricing, creating more predictable and constant network pricing. For this to occur, a consistent regulatory framework that operates for more than one regulatory control period is required.

Prescription and discretion

The Rule Change Proposals effectively eliminate any requirement for the AER to have regard to the forecast operational and capital expenditure requirements of a DNSP. Instead, it provides the AER with the discretion to determine what it considers is the operational and capital expenditure that will be required for each year of the regulatory control period.

Essential Energy is concerned that one aspect of the AER's Rule Change Proposals will be to remove some very important and relevant capital and operating expenditure factors from clauses 6.5.6(e) and 6.5.7(e) of the NER. The AER has not only proposed a change to the obligation that it *must* consider these factors to it *may, as it considers appropriate*, but the AER has further proposed the deletion of the building block proposal as a relevant consideration. This approach implies that the AER considers that a DNSPs building block proposal would never be an appropriate consideration when assessing appropriate levels of capital and operating expenditure. Essential Energy considers a DNSP's building block proposal, any submissions made on that proposal, and any published AER analysis conducted on that proposal, are appropriate considerations when assessing allowable capital and operating expenditure levels.

Essential Energy considers that the information provided by a DNSP in its regulatory proposal and in response to the Regulatory Information Notice (**RIN**) issued by the AER is crucial to determining whether operational and capital expenditure meet these criteria. The financial and operational information provided in the RIN is specific to each DNSP and is reflective of its

[1] http://minister.ret.gov.au/MediaCentre/Speeches/Pages/StrategicPrioritiesforEnergyMarketDevelopment.aspx

operational and capital expenditure requirements, which logically, can only be identified by the operator of each network. The AER is not in the best position to unilaterally determine, for example, the cost and timing of asset replacement or the effect on the network of peak demand growth.

Further, a more prescriptive approach to operational and capital expenditure budgets effectively places the AER in the position of an asset or capital manager. A prescriptive approach will result in the AER effectively determining the plan for network requirements without any recourse to shareholders or accountability for operational outcomes. An approach like this to allowable expenditure may place significant constraints on the ability of a network operator to manage an effective and efficient network and may act contrary to the National Electricity Objective in the promotion, and operation and use of, electricity services with respect to the "safety, reliability and security of supply of electricity".

AER's use of its discretion

Essential Energy believes the AER currently holds sufficient discretion with respect to forecasting capital and operational expenditure. The NER presently provides the AER with the ability to reject an operating or capital forecast proposed by a DNSP where it is of the view that the proposal does not "reasonably" reflect the efficient costs, the costs of a prudent operator and a realistic expectation of demand forecasts and cost inputs, required to achieve the capital and operating expenditure objectives. This is assessed against information provided by a DNSP, submissions received from interested parties and analysis undertaken by the AER (often by its external experts), to ensure that the AER is making the most appropriate determination based upon all relevant information available. Where the AER forms the view that the regulatory proposal put forward does not "reasonably reflect" the operating and capital expenditure objectives, it may choose not to accept the forecast of a DNSP and replace it with its own.

The solution

There are more preferable solutions to the perceived problems raised by the AER, many of which Essential Energy believes can be dealt with within the current regulatory framework.

In making its regulatory determination, the issuing of a RIN provides the AER with the ability to monitor and assess the validity of claims made by a DNSP which can then be relied upon by the AER as a true reflection of the capital and operational expenditure requirements of a DNSP.

Essential Energy believes the NER already necessitates the making of justifiable claims by DNSP's for operating and capital expenditure. These claims must be reflective of forecast demand and current infrastructure so as to meet the needs of those forecasts through submission of well evidenced proposals. In addition, the information submitted by a DNSP must be accompanied by Director sign-off attesting to the completeness and accuracy of information provided, so that the AER can rely on it to assess the DNSPs regulatory proposal.

By issuing a RIN, the AER has also required a DNSP to have specific information audited by a person with particular skill and expertise to allow it to assess compliance with the NER or a regulatory determination. This mechanism has allowed the AER to request audited historical information which substantiates the information submitted and provides a safeguard for the AER in assessing the validity of a claim for operational or capital expenditure over the term of a regulatory determination.

4. Incentive arrangements in electricity

The problem

The AER suggests that the current framework does not promote efficient outcomes in the long term interests of consumers through the mechanism for setting of forecast capital and operational expenditure. It contends that there are insufficient incentives for efficient expenditure. However, Essential Energy believes that, because only one year of audited data has been received for the Efficiency Benefit Sharing Scheme (**EBSS**), this conclusion may be premature.

In addition, Essential Energy notes that, under clause 6.5.8 of the NER, the AER has the discretion to develop an EBSS for capital expenditure. Essential Energy believes that, until this is developed, there is little basis for the AER to contend that the current regulatory framework does not provide the means for providing incentives for efficient capital investment.

Prescription and discretion

The AER is proposing to insert a new capital expenditure incentive mechanism into the NER. This proposed approach is highly prescriptive, but may not achieve the AER's objective. The prescriptive nature of the proposed capital incentive scheme is illustrated when comparing it to the EBSS. The EBSS was developed in consultation with industry and in compliance with the development of guidelines in the NER. The EBSS can be amended if necessary, as intended by the NER.

In Essential Energy's opinion, rules should not be codified where modification or fine tuning may be required in the future. Furthermore, hard wiring of rules means that they will apply in the same manner to all distribution and transmission businesses, and cannot be varied to take into account individual conditions and circumstances.

Essential Energy believes that a capital expenditure incentive scheme should be established in the same way that the EBSS and service target performance incentive scheme were – that is, through an AER guideline which provides flexibility when it is applied to each business.

AER's use of its discretion

As noted above, clause 6.5.8 of the NER provides the AER with the discretion to develop an EBSS for capital expenditure. The EBSS could be an effective mechanism and used to implement a scheme which incentivises economic efficiency to reduce capital expenditure. Because the AER has not used its discretion to implement such a scheme, Essential Energy finds it difficult to agree that, the current framework within the NER does not achieve efficient capital expenditure.

The solution

There are more preferable solutions to the perceived problems raised by the AER, many of which Essential Energy believes can be dealt with within the current regulatory framework. It would seem inappropriate to discard the current regime available to the AER where the incentive arrangements already in existence for capital expenditure are yet to be tested.

5. Cost of capital provisions in both electricity and gas

The problem

The AER proposes that the current framework in Chapter 6 results in DNSPs being able to "cherry pick" those component parameters of the WACC which they consider unfavourable to them. The AER considers this detracts from its ability to adequately consider the resulting overall rate of return. Whilst Essential Energy refutes this contention, it is acknowledged that there are some issues with the manner in which the debt risk premium is set and looks forward to exploring alternative solutions as part of this consultation process.

Prescription and discretion

In considering the AER's use of its discretion to date with respect to the WACC, it has been found by the Australian Competition Tribunal that such discretion has not been applied correctly in each case. The Tribunal noted in one decision that the AER:

> *"in reaching its decision, … has in any case placed no weight on the Applicants' expressed desire for certainty regarding the WACC for the purpose of securing capital for its investment program. An NSP is entitled to take whatever considerations it wishes into account in proposing an averaging period. However, neither the NEL nor the Rules provide any basis for the regulator taking account of a desire for certainty of that kind…Moreover, the NEL and Rules seek to ensure that an NSP operates and invests efficiently in the manner of a firm in a competitive environment. Such a firm would never have the luxury of knowing its revenues years in advance".*[2]

Therefore, any proposal that increases the discretion available to the AER to make determinations on the largest component of allowed revenue without any recourse for review is of concern to Essential Energy.

The solution

Essential Energy agrees that some amendments could be directed to the manner in which WACC is determined. Essential Energy acknowledges the method of determining the debt risk premium is an issue. It is currently giving further consideration to, and assessing, what may be the most appropriate means to address the debt risk premium. In addition, a mechanism needs to be developed to provide DNSPs with a safety valve to deal with abnormal financial events, such as those experienced during the global financial crisis.

Essential Energy is not necessarily averse to aligning the WACC process between electricity distribution, electricity transmission and gas networks. However, the Rule Change Proposals in the form suggested by the AER cannot be supported, due to the fact that the AER has proposed to remove both the persuasive evidence test and adopt the approach used for setting WACC under Chapter 6A of the NER, thereby removing access to merits review on WACC.

[2] Australian Competition Tribunal, Application by EnergyAustralia and Others [2009] ACompT 8, Corrigendum at 105.

6. Efficiency of the regulatory process

Essential Energy does not completely agree with the extent of the problems with the framework for economic regulation of electricity and gas networks as characterised by the AER. However, Essential Energy does consider that there are some minor amendments that could be made to enhance the efficiency of the regulatory process. Essential Energy is currently considering these issues further, with a view to detailing a position in the next phase of the consultation process.

7. Concluding remarks

National Electricity Objective

The National Electricity Objective is to promote efficient investment in, and operation and use of, electricity services for the long term interests of consumers. In setting this objective, price is one of five criteria of importance in ensuring the long term interests of consumers are met. Quality, safety, reliability and security of supply are paramount, not only to the supply of electricity, but to the national electricity system as a whole. To this end, the AER's concern with respect to price cannot be considered in isolation, as price is a product of the investment required to ensure that future electricity supply needs are secured for consumers.

Underinvestment

Significant restraints placed on the price of network charges have resulted in underinvestment over previous regulatory control periods. As a consequence, Essential Energy is currently building to cater for peak demand and renew ageing assets. Without sufficient allowable expenditure through the regulatory process, Essential Energy may struggle to meet future capacity requirements and uphold the National Electricity Objective.

Customer density profile considerations

Essential Energy's customer density profile adds complexity to its requirements for capital and operational expenditure. Essential Energy's network covers a significant proportion of NSW. However, customer density is low. Therefore, its capital and operational requirements are high per capita given the distances the network covers. In setting its required capital and operational expenditure, Essential Energy's customer density profile is a key determinant in the level of investment required.

Therefore, the AER's proposal to remove consideration of an individual DNSPs circumstances form the operating and capital expenditure criteria under clauses 6.5.6(c) and 6.5.7(c) is of great concern to Essential Energy and will result in a breach of the National Electricity Objective. Essential Energy supports the use of robust and rigorous benchmarking, which by its very nature, takes into account the individual circumstances of each DNSP. Essential Energy finds it concerning and difficult to reconcile the AER's intention to retain benchmarking as an operating and capital expenditure factor for use in assessing appropriate levels of expenditure, matched with its dismissal of considering the individual circumstances of each DNSP. This either indicates the AER's benchmarking approach will be less than robust and rigorous, or the link to individual circumstances needs to be reinstated by the AER.

Reform fatigue and regulatory burden

Any changes in the wording of the NER, including additions or deletions, will potentially have a significant affect upon the manner in which a DNSP prepares its regulatory proposal. Internal processes will need to be amended and refined to account for changes in the financial and operational management of Essential Energy's business. Given that the proposed amendments would result in the fourth iteration of the regulatory framework governing pricing determinations within three regulatory cycles, the regulatory burden of further, considerable amendments to the NER are significant.

Moreover, where investment certainty is in a constant state of regulatory flux, it is nearly impossible to assess the success of any regulation currently in force. The ever changing regulatory regime imposes a significant administrative and financial burden on network service providers, and the uncertainty created through constant change fails to create a stable platform where predictable and sustained future investment in network infrastructure can occur.

To this end, where the AEMC views that amendments should be made to the NER, at a minimum, transitional rules must be put in place to alleviate the burden on a DNSP prior to the next regulatory control period. Essential Energy's regulatory proposal will be largely complete by the end of 2012. The timing of this rule change has the potential to have significant implications for Essential Energy's next regulatory proposal which is due to be lodged with the AER in June 2013.

Regulator accountability

Essential Energy does not support a framework where the AER has full and unlimited discretion without accountability. The Rule Change Proposals dilute the provisions for merits review of its decisions. Where the Tribunal has found that the AER has made incorrect assessments which significantly affect the amount of allowable revenue for a DNSP in its recent determinations, Essential Energy advocates the retention of a safeguard to ensure that a right of review is available.