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Australian Energy Market Commission
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Lodged online: www.aemc.gov.au

Draft Determination on Economic Regulation of Network Service Providers

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Markets Commission on its Draft Determination on Economic Regulation of Network Service Providers.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

The Draft Determination and the accompanying Draft Rules represent a significant body of work by the Commission. We recognise that the Commission has had to evaluate a range of competing arguments from different stakeholders. We do not offer specific feedback on the detailed rules, but instead comment on the underlying intent of those rules.

Rate of Return

Setting an appropriate rate of return is one of the most critical elements of an energy network price control process. The framework for setting the rate of return needs to be predictable and stable in order to give stakeholders confidence in the process. Of particular importance in such a capital-intensive industry is that the investor community has confidence in the process.

One way to achieve predictably and stability is to have a heavily codified framework, with the process embedded in the rules. Broadly speaking this is the current situation. The AEMC's proposed rule changes moves away from this, and will ultimately result in more discretion for the AER.

It is not necessarily inappropriate for the AER to have greater discretion in the way that the rate of return is determined, but it is paramount that in doing so it is able to reassure networks, their investors and other stakeholders that it is doing so in a way that will deliver a reasonable decision on the allowed return. Consultation is a key part of this, but it is also valuable to recognise that the typical regulatory framework for setting a rate of return is draws heavily on theoretical assumptions as well as historical observations in order to make a forward-looking estimate of the required rate of return. In doing so there is a risk that the overall result may be incompatible with the return that is actually required by investors.

To avoid the chance of this outcome other regulators have developed methods to "sense-check" the theoretically-derived result with real-world expectations. For example, Ofgem, the British energy regulator has routinely carried out the following:

- Meetings with a range of potential and actual investors to discuss the proposed price controls and what sort of risks the investor group considered to be material
- An explicit "financeability" test using the financial model based on the level of key financial ratios across the price control period
- Cross-check of the financeability results with credit ratings agencies
- Adjustments to the revenue allowances where the financeability test highlighted potential concerns

These sorts of exercises may not necessarily be embedded in the rules, as they are representative of a *cultural* attitude of the regulator. If the AER is to be afforded more discretion then these are examples of the sorts of safeguards that will need to be built into the process.

Capital Expenditure Incentives

The basic format of the regulatory framework set out in the rules is one of incentive-based regulation. Implicit in this is that the driver of efficient spending by network service providers (NSPs) is the way the incentives are structured. It follows that if the incentives are not structured appropriately then an NSP may not spend efficiently.

One of the key elements of structuring incentives appropriately is to set the allowed rate of return at a reasonable level. Another is the power of the incentive to spend or not spend, both on opex and capex. For capex, specifically, the current framework leads to the power of the incentive being an outworking of a number of parameters, including: the length of the price control; the year of the price control in which the investment decision is made; the allowed rate of return; the deprecation rate on the asset, and whether depreciation is adjusted at the start of the next price control in line with the actual expenditure profile.

In particular, the actual power of the incentive (which is symmetrical for both overspending and underspending) declines through the price control period. This effect, sometimes known as periodicity, has raised concerns that NSPs may be incentivised to time their investment activity to be low at the start of a price control period and higher. However, we are not aware that any such inefficiencies have been specifically identified.

Nevertheless, calibrating the incentive rate more specifically may be beneficial. Setting the incentive at a specific percentage for example, is essentially a matter of arithmetic. What is critical is that the implications of high and low incentive rates are properly evaluated and the final level selected represents an appropriate balance of providing a clear incentive to spend efficiently without imposing excessive risk on the NSP.

Ex post efficiency review of capital expenditure

The AEMC's draft rules propose that the AER should carry out ex post reviews of capital expenditure where an NSP has invested more than assumed by the regulator in its revenue determination. Inefficient expenditure would not be rolled forward into the regulatory asset base (RAB). Implicit in the assumption that such a safeguard is necessary is an argument that incentives may be inadequate to prevent an NSP from ensuring al investment is efficient.

This supposition conflicts with the intention in the rest of the rule changes to ensure that incentives are appropriately calibrated. It also purports to be a remedy to a phenomenon – inefficient expenditure above the AER's baseline - that has not been clearly identified; more commonly, companies have spent less than their allowance.

As such the need for such a safeguard has not been established. This might matter little if implementing these rules was costless, but it is not. Firstly, it will use up part of the AER's limited resources, which would surely be better used on matters other than attempting to find inefficient expenditure that the incentive framework is designed to preclude. Secondly, it is no straightforward matter to decide, with the benefit of hindsight, how much an NSP should have invested. An aggressive approach by the AER could easily lead to legitimate expenditures that were made prudently and in good faith being deemed "inefficient" and disallowed. This risk to what is, by the time of the decision, sunk expenditure is a material risk for the investors that have funded the investment. As such, it puts upward pressure on the cost of capital.

The esaa urges the AEMC to remove these rules from its drafting and to ensure the focus is instead on getting the most appropriate incentive structure.

Capital and operating expenditure allowances

The overall effect of the proposed rule changes is to afford the AER greater discretion in setting the capital an operating expenditure (capex and opex) allowances. On the face of it this raises greater risk that the overall revenue allowance will turn out to be inadequate, and the AER will have to consider carefully how it minimises this risk (which will in turn be exacerbated by the threat of ex post review).

Whether these rule changes will prove effective in meeting the National Electricity Objective will depend in large measure on how the AER interprets and applies them in practice.

For example, an emerging theme in the regulatory debate is that customer representatives have found it difficult to engage fully in the revenue determination process. As a result, NSPs need to involve customers and their preferences more closely in the development of their business plans. For NSPs to be able to do this effectively, they need to understand how the AER will in turn evaluate the supporting evidence put before them. Anecdotally, NSPs that tried to demonstrate consideration of customers' preferences under the previous state-based regimes had their evidence rejected by the regulator. Customer consultation is also not costless and consideration of cost recovery for such activity must also be taken into account.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

Matthew Warren
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