AUSTRALIAN ENERGY REGULATOR

GPO Box 3131
Canberra ACT 2601
Telephone: (02) 6243 1233
Facsimile: (02) 6243 1205
www.aer.gov.au

Our Ref: 47776
Your Ref: ERC0136 & GRC0013
Contact Officer: Adrian Russell
Contact Phone: (02) 6243 1032

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John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets - Response to Consultation Paper

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the rule change proposals by the Major Energy Users Inc (MEU) on optimisation of the Regulatory Asset Base (RAB) and use of fully depreciated assets.

Please find attached the AER's submission in response to the Australian Energy Market Commission's (AEMC) consultation paper.

Yours sincerely

W. J. Anderson

Warwick Anderson
Acting Chief Executive Officer

AER Submission: Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets - Response to AEMC Consultation Paper

The AEMC is consulting on two rule change proposals submitted by the Major Energy Users Inc (MEU). The first proposal seeks to introduce a form of ex post optimisation of the Regulatory Asset Base (RAB) and the second proposal seeks to disincentivise the replacement of fully depreciated assets. The AER welcomes the opportunity to provide this submission in response to the AEMC's consultation paper.

This submission initially seeks to address each of the two rule change proposals submitted by the MEU in turn. It then concludes by outlining relevant additional proposals that the AER considers go some way to addressing the issues raised by the MEU.

Optimisation of the RAB

The first of the MEU rule change proposals seeks to introduce a form of ex post optimisation of the RAB based on an assessment of asset utilisation.

The AER agrees with the MEU that there is a need to strengthen incentives on network service providers (NSPs) to only incur efficient capital expenditure. In addition, the AER considers that there is merit in continuing to observe whether asset utilisation is being fundamentally affected by changes in the broader Australian economy.

The AER understands that a prime motivation behind the MEU proposal is the risk that as the economy adjusts to a low carbon future, there will be changes in the pattern of investment and the potential closure of existing plant. As a result, the MEU is concerned that consumers will continue paying for network assets that become either under utilised or completely stranded.

The AER agrees that there is a need to ensure that there are incentives for network businesses to use their assets efficiently and for potential generators/customers to locate in the parts of the network that have spare capacity.

At this stage, the AER believes that these concerns can best be addressed through mechanisms that focus on the:

- effectiveness of the planning processes;
- efficiency of capital expenditure; and
- pricing mechanisms that encourage efficient locational decisions.

While acknowledging that there is continued need for incentives that encourage NSPs to incur only efficient expenditure, the AER notes that the proposal to introduce an ex post review of the RAB based on asset utilisation would raise a number of issues that would need to be carefully considered.

The AER notes that an ex post review may be an intrusive and resource intensive process. There will also be issues to address in measuring and assessing asset utilisation in energy networks as part of the optimisation process.

In 2003, the ACCC initiated a *Review of the Draft Statement of Principles for the Regulation of Transmission Revenues*, with the intent of improving incentives for efficiency, improving the climate of investment through greater certainty and providing greater transparency about TNSPs' performance. In 2004, at the conclusion of this review, the ACCC outlined its intention to move away from periodic revaluation of the RAB[1]. The ACCC noted at the time that locking in the RAB provides the regulator with greater control over tailoring incentives and also provides more certainty than a revaluation approach as it addresses the potential risk to investment of periodic revaluation and avoids the risk of changes in replacement costs.

The AER also notes that under the MEU's proposal, the entire RAB would be up for consideration at each regulatory reset. This would give rise to a greater level of regulatory risk than an ex post regime which examines only investments that have occurred since the previous reset.

The current energy market framework strikes a particular balance between risk allocation, investment certainty and price outcomes. Clearly, any rule change will shift this balance to some degree. Under the existing framework the risk of under utilisation of network assets resides with consumers rather than NSPs. The AER considers that MEU's proposal would result in a reallocation of risk that may require further regulatory changes in the future.

Use of depreciated assets

The second of the MEU's proposals seeks to disincentivise the replacement of fully depreciated assets. The AER agrees with the need to ensure that effective use is made of all assets, including depreciated assets. However, we do note some issues with the rule change that would need to be considered.

It is not clear that MEU's proposed changes to rules 6.5.7 and 6A.6.7, as drafted, will alter the incentive on service providers to replace fully depreciated assets during the regulatory period. This is because the rule changes are proposed as an addition to the *capital expenditure factors* that the AER is to have regard to in the process of how the capital expenditure forecast is set, rather than affecting how the opening RAB for each regulatory period is determined based on past investment.

If the rule change requires asset-by-asset assessments of capital expenditure proposals on the basis of whether the existing asset is 'used and useful' significant assessment costs will be created. The AER considers it appropriate that NSPs undertake a risk/conditions based assessment of their assets as part of developing their asset replacement programs. In this regard, the trade off between maintaining older assets (which may, or may not, be fully depreciated) through additional operating expenses, or replacing them through capital expenditure, requires some flexibility and judgement.

Additional proposals

The AER notes that there are other proposals that may go some way toward addressing the issues raised by the MEU. For example, the AER has:

[1] ACCC, *Draft Statement of Principles for the Regulation of Electricity Transmission Revenues – Background paper*, August 2004, pg. 66.

- proposed rule changes to strengthen incentives for efficient capital expenditure;
- through the Transmission Frameworks Review, indicated a need to ensure that the pricing mechanisms encourage efficient location decisions by generators; and
- increased its focus on the compliance of network businesses with the planning and consultation processes in the Regulatory Investment Test-Transmission.

On the capital expenditure efficiency matter, the AER's rule change proposals include a new 40 / 60 sharing factor for any capital expenditure in excess of the ex ante forecast. The AER is of the view that the sharing mechanism it has proposed strengthens incentives to invest efficiently.

In addition to the measures designed to address the efficiency of capital expenditure that are outlined in the AER's rule change proposal, the AER suggests focusing on improving asset utilisation through mechanisms that improve the effectiveness of the planning processes and on pricing mechanisms that encourage efficient locational decisions. The Transmission Frameworks Review is considering the appropriate mechanisms to deliver clear and effective signals to generators and consumers to locate efficiently. Ensuring that the planning processes continue to develop is important, so as to minimise the risk that assets are built that may be under-utilised or stranded in the future.

To address the issue of asset replacement, the AER suggests further refining the capital expenditure and operational incentives that apply to NSPs. For instance, the AER is currently consulting on whether to introduce some form of network capability incentive for TNSPs.[2] This type of incentive would encourage TNSPs to devote resources to maintaining the capability of their existing network rather than focusing too heavily on new investments. TNSPs would be rewarded for improving the capability of existing infrastructure, and penalised for allowing network capability to deteriorate. The AER's rule change proposal also includes a proposal to allow the introduction of new incentive schemes, beyond the current efficiency benefit sharing scheme (EBSS), service target performance incentive scheme (STPIS) and demand management incentive scheme (DMIS), subject to the schemes meeting certain principles.

Another relevant aspect of the AER's rule change proposal is the package of measures that are aimed at ensuring the benchmark WACC is set in line with more realistic financing practices of the sector. This will help the regulated WACC be reflective of the required rate of return faced by businesses, which is necessary for a balanced capital expenditure incentive framework.

Conclusion

The AER considers that the MEU has raised two significant issues that are worthy of detailed consideration. These are the need for strengthened incentives to encourage NSPs to incur only efficient expenditure and to encourage efficient use of existing assets. While accepting the broad intent of the rule change proposals, the AER has noted some potential issues that would require consideration by the AEMC. The AER also maintains that its rule change proposal submitted in September 2011 represents a balanced package of measures capable of

[2] AER, *Electricity Transmission Service Target Performance Incentive Scheme*, October 2011, pg. 19.

appropriately addressing the key issues raised by stakeholders, including the MEU. In areas that are not directly addressed by the AER rule change, the AER has also noted some other policy processes in place that relate to the issues raised by the MEU, such as the Transmission Frameworks Review.