The Hon Tom Koutsantonis MP
Member for West Torrens

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Government of South Australia

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RECEIVED
09 MAY 2012

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

Dear ~~Mr Pierce~~ John,

Thank you for the opportunity to comment on the Australian Energy Market Commission's (AEMC) Directions Paper National Electricity Amendment (Economic regulation of network service providers) Rule 2012, National Gas Amendment (Price and revenue regulation of gas services) Rule 2012.

It is important that changes to the Regulatory Framework will result in the rules striking an appropriate balance between allowing the transmission and distribution network service providers sufficient expenditure to meet their obligations, while ensuring that any required price rises are efficient and in the long term interest of consumers under the National Electricity Objective (NEO).

The Department for Manufacturing, Innovation, Trade, Resources and Energy (DMITRE) has reviewed the AEMC Directions Paper and has developed more detailed comments, which are attached for the AEMC's consideration. Should you have any questions about this submission, please contact Mr Vince Duffy, Executive Director, Energy Markets and Programs Division of DMITRE on (08) 8204 1724.

Yours sincerely

Tom Koutsantonis

Hon Tom Koutsantonis MP
Minister for Mineral Resources and Energy

5th May 2012

Attach: submission from the Department for Manufacturing, Innovation, Trade, Resources and Energy

12-7.

Government of South Australia
Department for Manufacturing, Innovation, Trade, Resources and Energy

Reference: ERC0134

The Energy Markets and Programs Division (the Division) of the Department for Manufacturing, Innovation, Trade, Resources and Energy (DMITRE) Submission to the Australian Energy Market Commission's (AEMC) Directions Paper:
re: Directions Paper - National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012.

Capital and Operating Expenditure Allowances

In the AEMC's Directions Paper, the AEMC has indicated that it will seek to confirm that the policy intent regarding the role and power of the Australian Energy Regulator (AER) to test Network Service Providers (NSP's) forecasts, established by the AEMC in 2006, remains appropriate. This is in regards to the AER proposed Rules changes to address issues relating to the process by which forecasts of efficient capital expenditure (capex) and operating expenditure (opex) are approved.

It is important to note that the Ministerial Council on Energy (MCE) Standing Committee of Officials (SCO) Statement of Scope - July 2006 '*A National Legislative Framework for Gas and Electricity*' stated that the National Electricity Law (NEL) would not mandate a global presumption in favour of accepting a regulated entity's proposal (commonly known as propose-respond framework). Instead, a 'fit-for-purpose' model would be adopted, acknowledging that in any electricity network service provider proposal, there is such a range of dimensions that the capacity to require the regulator to apply either the 'propose-respond' or 'receive-determine' method, or a more specific test to different elements of a proposal, should be maintained. Accordingly, the NEL would not direct the AEMC as to the decision making standard for AER decisions but would ensure the service provider has an opportunity to make a proposal on pricing and revenue issues at the start of the process.

In arriving at the above decision the MCE SCO were informed by the Expert Panel on Energy Access Pricing final report (April 2006) which stated there was little doubt that a 'propose-respond' model would over time lead to a systematic increase in the returns to regulated entities relative to the 'receive-determine' model. In this model the regulator receives and considers a NSP's proposal (including submissions) and determines in relation to each component an outcome that in the regulator's view best meets the criteria.

As noted in the AEMC Directions Paper, during the development of Chapter 6A of the National Electricity Rules (NER), the AEMC introduced a form of the 'propose-respond' model and the concept of 'reasonable estimate', which is largely replicated in Chapter 6 of the NER. As acknowledged by the AEMC, this approach, by limiting the exercise of regulatory discretion and creating a presumption in favour of the NSP's proposals, it has essentially focussed heavily on the promotion of investment.

It is unclear whether the presumption in favour of accepting the regulated business' forecast is intended to be 'light handed' or intended to address 'information asymmetries', however, it is not desirable that the AER should be obliged to accept a proposal falling within a 'range of reasonableness'. By eroding the AER's authority this presumption potentially reduces the effectiveness of the approval process. In effect the current economic network regulation framework for regulatory decision making is biased towards network businesses, providing the AER with insufficient authority to determine efficient costs.

In order to redress that balance, the AER should receive an NSP's proposal and determine if the NSP's forecasts meets efficient expenditure investment that is in the long term interests of consumers under the National Electricity Objective. Essentially this becomes the 'receive-determine' model.

As a result therefore, the 'reasonably reflects' condition in the NER is removed and as the AEMC consultants in the Directions Paper have suggested, which is supported by the Division, the NER Chapter 6 constraints which limit AER substitutes to those 'only to the extent necessary' and 'on the basis of' the original forecast would become superfluous.

Consistent with having a less prescriptive approach in regulatory decision making, the AER would have more discretion to determine the efficient level of expenditure investment through the range of tools available in the NER, including ensure the AER has regard to the NSP's proposal, submissions and benchmarking.

The Division supports the removal of any constraints in the NER that may limit the AER's ability to apply benchmarking in identifying efficient costs.

Capital Expenditure Incentives

The Division does not support the AER's proposed rules to amend the RAB roll forward mechanism so that only capex up to the forecast would be automatically added to the RAB (known as the 40/60 (shareholders/customers) sharing factor mechanism).

The Division notes the AEMC's view that the NER does not provide NSPs with an incentive to spend more than the capex allowance, although there may be incentives on NSPs to defer capex in an inefficient way.

The Division considers that the AEMC should consider a symmetrical efficiency benefit sharing scheme (EBSS) which is supported by an ex-post review on Regulatory Investment Test (RIT) for projects above a pre-determined threshold. The benefits of a symmetrical EBSS are that it provides both rewards and penalties to incentivise NSPs to maintain capex at the level allowed by the AER.

The EBSS should not encourage inefficient substitution from capex to opex and it should be flexible enough so as to not lead to inefficient deferral of otherwise efficient and required capex or demand management projects.

In order to control capex, measures such as benchmarking and the use of actual rather than forecast expenditure values for the EBSS should be further developed.

To address the 'supervision gap' identified by the AEMC, the Division suggests a limited ex-post review mechanism to support the EBSS. The Division notes the issue of evidentiary burden the regulator must satisfy before it could disallow an investment in a ex-post review of the efficiency and prudency of capex, and has therefore suggested that only projects above a threshold (to be determined) be examined. For projects above the threshold, the regulator needs to strike a balance between necessary network investment to ensure reliability and scrutiny of any over-spending to verify that it is appropriately justified.

Appropriately, the above scheme proposed by the Division should be established through a guideline developed by the AER, using prescribed principles established by the AEMC, as this would allow for flexibility in application and refinement over time, as circumstances arise.

Rate of Return on Capital / Weighted Average Cost of Capital

The Division considers there should be a common framework for WACC applying over all networks and that the basis of the weighted average cost of capital (WACC) calculation and methods should be as specified in Chapter 6 of the National Electricity Rules. Additionally, this framework should have the values of parameters removed from the Rules and determined once every five years by the AER's Statement of the Cost of Capital. The Division notes that some parameter values such as the risk free rate of return and to the Debt Risk Premium (DRP) will need to be updated for current market conditions at the time of each regulatory determination. These parameter values could then be reflected in the AER's Framework and Approach Paper that precedes each regulatory determination.

With regard to the DRP, the Division considers that the AER should specify the method for DRP. The AEMC should ensure that the Rules provide sufficient detail for networks to be able to present DRP values in their regulatory proposals from a consistent source of debt indicators, determined by the AER.

As a consequence of this proposed framework, the Division sees no reason for a persuasive evidence requirement in the Rules and would not support either the AER or Energy Users Rule Change Committee proposals for DRP.

The Division supports a merits review process applying to the WACC parameters, noting that errors can be made and these parameter values are of upmost importance. However, the Division also notes and supports the AER's contention that the current limited merits review process allows for the cherry picking of parameters for review.

An option which should be explored by the AEMC is for the ACT to identify issues with the AER's determination on WACC parameters, however, rather than determining the correct value of these parameters where an issue has been identified, to return the matter with guidance to the AER to determine the final values.

To this end, the Division notes that any analysis undertaken by the AEMC in this area may need to be progressed through Standing Council on Energy and Resources Limited Merits Review project.

Consumer engagement

Concerns have been raised that the current Regulatory Framework does not provide consumer's with sufficient opportunity to be involved in a meaningful way. The Division notes the AEMC view that the regulatory framework does not include barriers to consumer engagement, however, considers that the complexity and technical nature of the material may cause individual consumer groups to not become highly involved due to the resources necessary for strong representation.

The Division is supportive of the establishment of a central consumer group which would advise existing individual consumer groups preparing submissions. The central consumer group would need to include representatives which are skilled and experienced in the business of NSPs to ensure they have the ability to analyse the information submitted in the process. It is important that the central consumer group be involved in all regulatory processes to increase proficiency and develop NSP and AER relationships.

The AEMC should note that providing for increased consumer engagement through delaying the AER's final determination will impact retail pricing processes, including the price regulation process in South Australia.

REBECCA KNIGHTS
ACTING EXECUTIVE DIRECTOR
ENERGY MARKETS AND PROGRAMS DIVISION
RESOURCES AND ENERGY GROUP
// / 4 /2012