Australian Energy Markets Commission

MEU Response to AEMC
Draft Rule Change Amendments

Economic Regulation

of

Electricity and Gas Network Services

and

Rate of Return Framework

Submission by

The Major Energy Users Inc

October 2012

Assistance in preparing this submission by the Major Energy Users Inc was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd. The content and conclusions reached are the work of the MEU and its consultants.

This project was part funded by the Consumer Advocacy Panel (www.advocacypanel.com.au) as part of its grants process for consumer advocacy and research projects for the benefit of consumers of electricity and natural gas. The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

TABLE OF CONTENTS

	Page
Executive Summary	**3**
1. Introduction	**5**
2. Rate of return framework and cost of debt	**11**
3. Capex and Opex allowances and factors	**20**
4. Capex incentives	**21**
5. Regulatory determination process	**27**

Executive Summary

The Major Energy Users Inc (MEU) welcomes the opportunity to provide its views on the proposed amendments to the network regulation rules. These are a response to the amendments proposed by the Australian Energy Regulator (AER) and reflect the extensive debates that have been held over many months.

The AEMC draft rule change amendments will go some way reversing over incentivisation provided to energy networks initiated by the 2007 transmission revenue and pricing rules. As history has shown, the economic regulation of energy networks over the past five years has been a failure, as the outcomes of the last cycle of network regulation have resulted significantly escalating network costs and prices which were driven by gold plating and over investment. As a consequence of these massive price rises, there have been severe economic and social consequences for consumers.

Whilst the MEU supports most of the AEMC's draft amendments, there are a number of areas and issues where the AEMC has not gone far enough in reducing or minimising incentives for potential over investment by the networks. This is highly regrettable as it not only represents a missed opportunity to redress the cost/price trends over the past network regulation cycle, but poses a potential risk that the amendments will not constrain monopoly networks over claiming future costs and revenues.

The AEMC's draft decision has effectively assumed that State owned networks will access debt at market rates, rather than through the State finance corporations at lower costs for the debt raised. This assumption is not supported by any evidence – in fact the evidence is that State owned networks do secure debt at lower costs than the privately owned networks. Nearly 80% of all electricity network assets are owned by State governments so the cost impost to consumers of this assumption will be significant and implicitly will cause most consumers to pay higher charges for their electricity transport than is needed.

The reasons provided by the AEMC to support its draft decision regarding debt costs are not convincing or supported by evidence; they certainly do not reflect the actualities faced by consumers. The failure by the AEMC to recognise such commercial realities in the 2007 was a major factor in its transmission revenue review which led to the current Rules being considered to be biased towards the networks and in need of changes now accepted as being needed.

The AEMC's draft decision that it does not see that there is a basic capex incentive embedded in the structure of the regulatory approach set within the National Electricity Rules reveals a basic lack of understanding of how capex is controlled in the real world of commerce. The assumption that, if actual capex (regardless as to how it has been used) has the same (or lesser) value to the ex ante capex allowance provided by the regulator, the actual capex will be efficient and allowed to be rolled into the asset base, is a bold assumption indeed. To constrain the AER to only be able to exclude any actual capex if the total amount of actual capex exceeds the allowance, is simply not in the best interests of consumers.

The AEMC recognises that actual capex might not be efficient and requires the AER to monitor (ex post) whether such capex was efficient. What the AER does with this information is limited in the extreme. Regardless of the AER conclusions, the capex is assumed to be efficient provided that the actual capex does not exceed the capex allowance. Presumably, the AER is to use such knowledge in its assessments of future capex allowances, yet there is no guidance as to how this is to occur. Even if the AER does assess future allowances on the basis of acceptable future work, there is still no restraint on the network using the allowance for other (inefficient) tasks. Even the AEMC consultant (PB) implies that there are no “teeth” in the new draft rules.

The AEMC draft decision assumes that a regulated firm will provide a benefit to consumers by the efficient deferral of capex. The draft decision does not address the essential asymmetry in capex deferral that incentivises a network to defer investment because by doing so it can retain all of the benefit of such a deferral for itself, whether this deferral is within a regulatory period or between periods.

The MEU strongly considers that consumers’ interests deserve a better appreciation of commercial realities than the AEMC has provided in its draft decision. There are potentially many sizeable “holes” in the draft rule amendments that will still provide over incentivisation and which drive network investments and cost claims higher than is necessary in the next regulatory pricing cycle.

The MEU attempted to fill some of these “holes” in its proposed network rule changes and it notes that there has been some attempt in the AEMC draft rules to address some of the MEU concerns. Unfortunately, the AEMC has not entirely addressed all the MEU concerns.

1. Introduction

1.1 Overview

There is little doubt that electricity and gas prices to consumers are growing at a rates far in excess of general inflation. This observation has been noted by many independent parties and has been most recently demonstrated by the decision to undertake a Senate Select Committee review into high electricity prices.

It has also been observed that one of the main causes of this massive increase in energy prices has been the regulatory framework developed in 2007 for electricity transmission networks by the AEMC, which has resulted in a significant shift in incentives to allow network businesses to increase their costs and minimise the ability of the regulator to limit the excessive claims for increased costs. These rules were opposed by consumers, including the MEU, and the AER, but their concerns were largely put aside. The rules developed for electricity transmission were then generally applied to electricity distribution network regulation in 2008 and then to gas network regulation in 2009.

As a result of the failed approach to economic regulation of networks, the Australian Energy Regulator (AER) proposed a series of changes to the electricity and gas rules to redress this imbalance of incentives, which had allowed the networks to receive significant increases in revenues for the provision of energy transport on their networks.

As a result of the proposed rule changes, the AEMC has instituted a series of consultation and discussion papers and workshops and this obtained strong stakeholder engagement into the rule change assessment process. In this regard, the Major Energy Users Inc (MEU) welcomes the opportunity to respond to the AEMC draft rule change amendments.

In general, the MEU supports most of the AEMC draft amendments.

However, there are a number of areas/issues where the MEU considers that the AEMC has not gone far enough in reducing or minimising the incentives for over-investment by the networks. For example:

- Whilst recognising the difficulties in having in the Rules different rates of return for networks to reflect the differences in incentives of state versus private ownership, there needs to be certain rules implemented that prevent state-owned networks from taking advantage of their lower cost of capital to embark on spending sprees, especially in light of the observed experience of inadequate governance arrangements applying to state owned networks during the previous price review round..

- The MEU is not convinced with the AEMC's relaxed attitude vis-à-vis capex incentives. The issue of backloading of actual capex is a serious one and poses risks for consumers
- We are not convinced that the ex-post audit of the RAB should be capped.

We address these and other concerns in more detail in the later sections of this submission.

1.2 The definition of the term "efficient"

In the Energy Objectives and throughout the AEMC analysis and the rules there is frequent reference as to the need for investment, allowances and network operation to be efficient. The MEU considers that the term needs to be clearly defined as it is clear that there are different views as to what is considered to be efficient in terms of regulation. The MEU considers that such an approach is appropriate because the drafters of the Energy Laws saw that such was necessary and clarified what was intended through the use of the second reading speeches. There is no reason that this practice should not extend into the new Rules for the guidance of the AER when it is permitted to exercise its discretion.

With a clear definition in the rules as what is considered to be efficient, this will set a benchmark against which the AER can assess claims for costs in setting the regulatory allowance for a network.

As a starting point, the second reading speech when the National Electricity Law was introduced in 2005 stated:

> "The market objective is an economic concept and should be interpreted as such. For example, investment in and use of electricity services will be efficient when services are supplied in the long run **at least cost**, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities.
>
> The long term interest of consumers of electricity requires the **economic welfare of consumers, over the long term, to be maximised**. If the National Electricity Market is efficient in an economic sense the long term economic interests of consumers in respect of price, quality, reliability, safety and security of electricity services will be maximised." (Hansard: SA House of Assembly 9 February 2005 page 1451) (emphasis added)

Unfortunately, all too often, the concept as to what is efficient is not applied in terms of how the second reading speech defines "efficient". It is clear from this definition that an efficient outcome will be to provide an outcome for consumers that will be **at least cost** and that the **welfare of consumers [will] be maximised.**

The second reading speech emphasises that the least cost and welfare of consumers is to be assessed over the long term. It is interesting to note that the Limited Merits Review Expert Panel discusses this feature in its assessment of the appeals process. The Panel obviously sees that the aspect of the long term interests needs clarification and that there might be differing views as to how this aspect of the Energy Objectives can be interpreted.

In their Review of the Limited Merits Review Regime stage one report, the Expert Panel comments:

> "Specifically, assessing the 'long term interests of consumers' – the criterion that lies at the heart of the NEO and NGO – requires a balancing of the consequences of regulatory decisions for potentially conflicting purposes (promoting the interests of consumers today and promoting the interests of consumers tomorrow)." (page 6)

They go on to state:

> "It is the long-term interests of consumers that are relevant. This cannot reasonably be interpreted as meaning that the interests of consumers today are irrelevant, and that the only thing that matters is the welfare of energy consumers at some distant point in time. It does, however, mean that it is not just the interests of consumers who will vote in the next election that count: there are future generations also to be taken into account. To the extent that the AER is required to engage in 'balancing' judgments, the chief balancing required is between the interests of consumers at different points in time." (page 37)

It is quite clear that the long term interests of consumers needs to be assessed under two aspects. If, for example, an issue has no long term effects, than the long term interests of consumers will be the same as those of present consumers and this is how the impact should be assessed. If, for instance the interests of future consumers might be different to those of current consumers, the decision needs to balance the interests of both, with a bias to the interests of future consumers.

When the issue of defining "efficient" is combined with the views of the "long term interests" having clear definitions of both these aspects included in the rules will provide a benefit to the AER when exercising its discretion to reach decisions.

For example, in the case of setting the debt premium, there is no long term benefit (ie a benefit for long term consumers) for current consumers to provide an NSP for a debt premium that exceeds their current costs for the provision of that debt. The requirement of the Energy Laws that the allowance be efficient supports the requirement that the debt premium be provided at the least cost to consumers as this is the efficient level. The long term interests of consumers would be the same as those of current consumers and therefore there is no need to balance increased costs to current consumers against lower costs for future consumers.

The MEU therefore considers that the rules need to define these critical features of "efficiency" and "long term interests of consumers" so that there can be no doubt as the basis of which the AER will be required to exercise its discretion.

1.3 What is regulation intended to provide

In discussions the MEU has had with the Limit Merits Review Expert Panel, it became clear that the prime purpose of a revenue reset review was to set a "bucket of money" which the regulator considers provides sufficient revenue (but not more) for the network owner to provide the required services. The current rules provide a mechanism for the regulator to develop what it considers to be an appropriate allowance through the use of the building block model.

In its Review of the Limited Merits Review Regime Interim Stage Two Report the Expert Panel comments:

> "…it can be noted that there has been, throughout the course of the review of the LMR, a body of opinion to the effect that it is the intention of the NER and the NGR that, in making price/revenue determinations, the AER is required to confine its evaluations to specific matters identified in the rules, and then to reach a final determination by, without further ado, simply adding up the results of these piecemeal exercises (sometimes referred to as the 'bottom up' approach). The Panel does not believe that this is a sensible interpretation of the policy intent – as is illustrated by the defects in the cost-of-capital outcomes identified in Stage One – but, given the persistence of the view, it might be appropriate for the Panel to recommend that any ambiguities about the intentions of public policy be resolved via rule changes, and that the relevant issue be thereby put firmly to rest." (page 11)

In effect, what the Expert Panel appears to be stating, is that regulation is intended to be seen in a holistic way – as a complete entity – and not seen as a series of discrete elements. By forming this view, it becomes clear that the AER is required to develop a total allowed revenue which *in its totality* provides a decision as to what is an efficient allowance, regardless of the method of its development.

This concern raised by the Expert Panel goes directly to the core of the regulation of networks The MEU considers that the rules should include a clear statement that the regulatory allowance is to be seen as a holistic assessment and not a series of discrete elements which have been added together.

1.4 State vs Private ownership

The LMR Expert Panel makes a further observation about regulation.

In its Interim Stage Two Report the Expert Panel makes an observation about:

> "…policy concerning the *ownership* of network service providers, and in relation to ownership issues the following can be noted:
>
> - The NER and NGR are based upon an economic approach developed for the regulation of *privately owned* utilities.
> - Whilst the approach can, and has, been applied to state owned entities international experience tends to indicate that it is more difficult to get to work effectively. Underlying issues include a relative lack of incentives to reduce costs in publicly owned monopolies, and intra-government conflicts relating to the supervision of publicly owned monopolies (most typically between that part of government responsible for performing shareholder functions and the regulatory authorities)." (page 12)

This is a very important observation, as the regulatory regime (and its associated rules) is predicated on incentive regulation. The Expert Panel is of the view that incentives for privately owned firms need to be different to those for publicly owned corporations. This means that the incentives that are integrated into the rules need to reflect this fact.

To a large degree, the rule change proposed by the EURCC is based on the fact that publicly owned corporations are able to access debt at levels well below the levels privately owned firms can. This disparity results in publicly owned corporations being awarded a much higher cost of capital than they incur, with the result that there is a much greater incentive for publicly owned corporations to over invest than applies to privately owned network providers, which face a different set of discipline..

The MEU considers that the new rules must reflect that there needs to be different incentives applied to privately owned NSPs than are applied to publicly owned NSPs.

1.5 Tension between the NEO/NGO and RPP

The development of the Energy Rules is predicated on the Energy Law Objectives (NEO and NGO) and the Revenue and Pricing Principles (RPP).

As discussed in section 1.2 above, the Energy Law Objectives are that the outcome delivers the least cost for consumers over the long term and that consumers' welfare be maximised.

In contrast, the RPP discusses the needs of networks in terms of minimum requirements that the rules must deliver to NSPs especially in terms of at least the recovery of efficient costs and a rate of return that reflects the risks faced by the NSP.

These differences in emphasis mean that there is tension between the Objectives and the RPP.

The rules should therefore provide guidance as to how this tension and dichotomy between the two sets of Law requirements must be managed. The MEU considers that the Rules should provide a view that:

- The Rules are designed to ensure that the NSP is granted recovery of its efficient costs but no more, as the Objective requires the services to be provided at least cost
- The rate of return should reflect the risks inherent in providing the services, but if risks are transferred to consumers (or tax payers), then the rate of return should reflect the lower risks faced by the NSP.

1.6 The structure of this response

The structure of this submission from the MEU follows the same structure of the AEMC Draft Rule Determination.

The following four sections of this submission address:

- Rate of return and cost of debt
- Capex and opex allowances
- Capex incentives
- Regulatory process

2. Rate of return framework and cost of debt

The Major Energy Users Inc (MEU) agrees with the AEMC that:

- There is a strong case for a common framework under the NER (including as between transmission and distribution) and NGR for setting the rate of return

- Requires the regulator to determine a rate of return that meets an overall objective focussed on the rate of return required by a benchmark efficient service provider

- The regulator develops, after consultation, the rate of return guidelines setting out the approach it intends to take, with the guidelines reviewed at least every three years

- The regulator and the appeals body focus on whether the overall estimate of the rate of return meets the overall objective for the allowed rate of return, which is closely linked to the NEO, the NGO and the RPP

- The regulator decides on the best approach for determining a rate of return.

The MEU supports the Commission's broad approach on its proposed common rate of return framework:-

> "The Commission's proposed rate of return framework therefore has an overall objective for the allowed rate of return. In order to meet the NEO and the NGO, this objective reflects the need for the rate of return to correspond to the efficient financing costs of a benchmark efficient entity with similar circumstances and degree of risk as that which applies to the service provider whose rate of return is being determined." (AEMC Draft Rule Determination Paper, Page 46)

However the MEU support is qualified in two key aspects.

Firstly, the rules need to define what is considered to be a benchmark efficient entity and the basis on which this is to be identified. Considerations such as whether this benchmark entity is:

- Assessed on a national or international basis
- Just based on energy network service providers or use a wider scope of entities accessing debt and equity,
- Based on the total rate of return or just the elements that are used to develop the benchmark,
- Reflective of the actual costs incurred by entities.

The MEU considers that the regulator should be required to assess the calculated rate of return allowed to regulated networks and to benchmark this across a much wider basis than just energy network service providers. This will allow the regulator to identify if the allowed rate of return exceeds the risk profile of the firm compared to returns achieved in the competitive market

Secondly, as noted above, the rates of return for privately owned NSPs will be different to those required by publicly owned NSPs which are able (and in some cases required) to access debt from their state government finance corporations at lower rates than is available to privately owned NSPs. This means that the benchmark entity will have to be different depending on the basic ownership structure.

2.1 Best practice in securing debt

There has been extensive debate during the review of the proposed rule change as to the basis on which the rate of return should be developed. There was not any argument that the rate of return should not be efficient and there was no view that it should not reflect best practice, especially in terms of securing debt. The issue of best practice recognises that the market is constantly changing and therefore the tools for accessing debt the most efficiently will constantly change. The rules must therefore be crafted in such a way that the regulator must have the flexibility to assess the most efficient way of securing debt at the time the regulatory decision must be made. To constrain the regulator as occurs in the current rules must be avoided.

The concept of best practice is core to ensuring that the way debt is secured is done in the most efficient way so that consumers can benefit from the incentive regulation which is the basis for energy market regulation. Incentive regulation is based on the premise that the regulated entity will use all of its skills to reduce the costs it incurs in providing the service. Just as there are programs for efficiency sharing for opex (the Efficiency Benefit Sharing Scheme – EBSS) so should there be a methodology whereby a regulated firm should be encouraged to be more efficient in the securing of its debt – recognising that debt is a cost for the regulated firm, just as opex and capex.

As a minimum, it would be expected that the structure the regulated firm has previously accessed its debt will provide guidance as to the expectation of future debt structure. Therefore, it would be expected that the regulator should be required to analyse the way the regulated firms have accessed debt in previous years as this is likely to indicate the most efficient approach to debt provision. This means that the rules need to require the regulator to examine the historical approach used by the regulated firms so that it can assist in identifying the most efficient structure for debt acquisition.

The allowed rate of return objective for electricity networks is:

> "The allowed rate of return for a [network service provider] must correspond to the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the [network service provider] in respect of the provision of prescribed …services."

The allowed rate of return for gas networks has a similar structure.
The MEU notes that the draft rules require that the return on debt would be based on the structure that an efficient entity would provide efficient financing costs. This is an appropriate test and allows the regulator to assess what might be seen as an efficient debt financing structure.

2.2 The cost of debt and network ownership

The MEU agrees with the AEMC that:-

- As the return on debt is part of the overall allowed rate of return, it should reflect the efficient financing costs of a benchmark efficient service provider, and try to create an incentive for service providers to adopt efficient financing practices, minimise the risk of creating distortions in the service providers investment decisions, and that shareholders (and not its customers) should bear the financial consequences of inefficient financing practices.

- The regulator can consider a range of approaches to estimating the return on debt to meet the overall rate of return objective, including approaches that involve averaging estimates of the return on debt over historical periods

- The regulator is best placed to assess the characteristics of a benchmark efficient entity, consistent with the overall rate of return objective

- The regulator (and the service provider in its regulatory proposal or access arrangement proposal) has the discretion to propose an approach in estimating return on debt that it considers best meets the overall allowed rate of return objective.

However, the MEU considers that there must be recognition that state owned and privately owned networks access debt in different ways which means that state owned networks incur lower costs for their debt than their privately owned comparators.

Following on from the comments in 2.1 above, what could be construed from the drafting is that the efficient debt-cost structure would be to access debt from a state government finance corporation. There is no doubt that government sourced debt is available only to government owned network corporations. The AEMC provides considerable discourse on whether there should be differentiation between government and private ownership.

The implications of this differentiation are discussed in general terms in section 1.4 above, but if a government owned network can access debt at rates less than are available to privately owned networks (as is currently the case), then applying the concept of a single efficient benchmark entity implies that the efficient benchmark entity will be based on the cost of debt to a privately owned entity. The outcome of this is that government owned networks will be granted an effective premium in the cost of debt and this will cause consumers a significant disadvantage. As government owned electricity network comprise nearly 80% of the assets involved, to impose a debt cost based on what privately owned networks have to pay, will result in significant and unnecessary overpayments by consumers. This is an unnecessary premium and is not in the long term interests of consumers.

The AEMC comments that:

- Having a differentiation would be contrary to the competitive neutrality principles,
- State finance corporations charge a premium for debt that replicates the cost of debt paid by privately owned entities
- Having a lower cost of debt would distort resource allocation
- Would result in geographical price distortions
- Distort sale or divestiture of state owned network assets

As discussed by the LMR Expert Panel, there are differing incentives that apply to state owned networks and therefore there is a basis for there to be differing treatment of them compared to privately owned networks. The MEU agrees with the Expert Panel and addresses each of the points used by the AEMC to argue against having any differentiation.

Competitive neutrality

The MEU concurs with the AEMC in its argument that competitive neutrality must be maintained. What the AEMC fails to address is that none of the networks competes with any privately owned network – that each network is recognised to be a monopoly – and this is why regulation is necessary.

It is simply absurd to argue that a monopoly network needs to be assessed in terms of competitive neutrality as if there was a competing network operating in the same geographical location as the government owned entity. Networks do not compete (they are, after all, monopolies each with their own franchise area of operations) so competitive neutrality principles simply do not apply in the same way as to many other government services which have direct competition operating in the same location.

The AEMC comments that competitive neutrality is an issue for governments and that the Competition Principles Agreement (CPA) is not an issue for the rules. The MEU agrees with the AEMC on this but points out that the rules are designed to provide for an efficient outcome for consumers. The rules therefore must not allow costs to be included that are not efficient and allowing state owned networks to levy a cost premium that is not incurred for the provision of the service can only be seen as inefficient.

In its argument, the AEMC confuses the CPA with efficient costs needed by a government entity which provides a monopoly. The MEU considers that this issue can be addressed by allowing the regulator to assess the issue in another way.

A premium is charged by finance corporations

Government finance corporations borrow funds based on the credit rating of the government seeking the loans which are considerably lower than the cost of debt accessible by private firms

There is no doubt that government finance corporations do levy a premium on the debt they provide to the state owned networks and this premium is added to the costs the finance corporations incur in borrowing from the wider market. The premium reflects the mandated debt neutrality or government guarantee fees applied to debt provided to government instrumentalities.

However, analysis[1] of this premium added to debt sourced using state government credit ratings shows that the cost of debt actually incurred by the networks is still considerably less than the cost of debt the network would incur if the debt was sourced externally. To assume (as the draft determination implies) that the difference between the cost of borrowing and the assumed cost of borrowing should be allowed, does not meet the requirement that costs are to be efficient.

Benchmark debt vs actual cost of debt

The AEMC states that the premium on borrowings provided by state finance corporations adjusts for the credit rating of the state government owners.

This is simply not true as a review of the debt costs for state government networks with those of private owners of network shows[2].

[1] This can be readily seen from the annual reports of government owned networks when compared to the annual reports of privately owned networks
[2] These are seen in annual reports

Government owned networks pay considerably less for their debt than do private owners of networks.

Resource allocation distortions

The AEMC comments that if a lower rate of debt was used for government owned networks, this would distort investment solutions when comparing network solutions with non-network solutions. The MEU agrees that this is a concern but points out that non-network solutions are a small part of the overall investment process with the bulk being used for network solutions and therefore should not be the driver for using an unnecessarily high debt cost.

The concern could be readily addressed by requiring comparisons between network and non-network solutions to investment needs to be based on the cost of debt as assessed for privately owned networks rather than that used by government owned entities. Once the assessment has been made, the actual cost of debt can be used for regulatory purposes.

Geographical market distortions

The AEMC expresses concern that using a lower cost of debt for government owned networks could influence generator investment and demand side responsiveness due to “artificial” incentives.

As with resource allocation distortions, this is a relatively small contributor to the costs of network regulation and is another case of the “tail wagging the dog”. Already there are massive differences in network costs between regions and to isolate this one concern as a driver for forcing unnecessarily high costs is overstating the issue considerably.

Sale or divestiture of state owned NSPs

The implicit concern with the sale or divestiture is that, should this occur, there might be a price shock for consumers and that an acquirer of the assets might pay less than the full value because of the low cost of debt.

Price shock for consumers cannot be a real concern because consumers have seen year on year network prices rise by as much as 50% and more in some cases. When this occurred there was no aspect of concern raised by the AEMC. Consumers would prefer to see efficient prices now and face the price shock if and when this occurs.

The issue of asset sale or divestiture could be readily accommodated by making it clear in the rules, or the AER guidelines, that on sale of government owned assets to a private entity, the cost of debt would be set at the private entity rate. As the draft rules already permit the changes in the cost of debt to be set based on a defined method as an alternative to a defined rate for the entire regulatory period, then this method could also address alternative ownership structures and thereby avoid this concern.

Summary of reasons not to reflect ownership

The AEMC has provided a suite of reasons not to reflect the lower cost of debt available to state owned networks. In practice, most are a case of the “tail wagging the dog” and impose considerable and unnecessary costs on consumers. Where there is a real concern, the matter can be readily addressed and implemented in another entirely acceptable way.

The provision of debt is a cost to the network entity and should be treated in this way so that the most efficient outcome is achieved for consumers as is required by the Energy Objectives.

The MEU considers that the new rules need to reflect the pragmatism that a large proportion of the electricity networks are government owned and can access debt at a considerable discount to the cost of debt that private entities incur. There is no doubt that in practice state owned networks can access debt at lower rates than are available to privately owned networks, and it is clearly inefficient to allow state owned networks to recover the cost of debt at rates higher than they incur.

The MEU is concerned that leaving the current wording of the draft rules will not allow the regulator to differentiate between privately owned and publicly owned networks and their differing abilities to secure debt funding.

2.3 Term of the regulated rate of return

There has been considerable debate as to the basis of the regulated rate of return. Currently the rate of return is based on the 10 year Commonwealth bond rate. Using this, the debt risk premium is derived from 10 year corporate debt[3]. There is an essential inconsistency in this approach, especially where the regulatory period is less than the 10 year bond rate used as the basis for developing the regulatory rate of return.

In its recent decision, the Western Australian energy regulator (ERA) recognised this and introduced a regulatory rate of return using the 5 year Commonwealth bond rate as the basis for the regulatory reset for Western Power – the electricity network service provider in Western Australia. The

---

[3] The equity premium is derived from the long term market accumulation index and the 10 year Commonwealth bond rate.

ERA then accessed data based on the structure of the 5 year bond rate as it considered this was reflective of the rate of return needed for the regulatory period.

The MEU notes that the draft rules imply that the rate of return calculated for different regulatory period durations can vary. On this basis the rate of return for a 5 year regulatory period might be different to a rate of return calculated at the same time for a 10 year regulatory period. The MEU considers that this is appropriate as it reflects the differing risk profiles associated.

2.3 Variable interest rates for the cost of debt

The way the draft rule is formulated, it is clear that the return on debt can vary within a regulatory period by proposing a method for setting the rate of debt which is based on inputs that could vary year on year after the first year of a regulatory period. This would allow a change in the allowed revenue because the cost of debt changed.

It is not clear whether this ability will be allowed to be sought by a regulated firm or it will be unilaterally initiated and determined by the regulator. The MEU is concerned that if such an approach is permitted to be initiated by the regulated firm, then it will introduce a method that allows for “gaming”. For example, if the regulated firm was of the view that interest rates were to fall, it would fix the rates to lock in a better return. Conversely, if it was expected that rates were to rise, then the regulated firm would seek to allow the interest rates to rise, increasing the allowed revenue.

There has been considerable debate about whether revenue allowances should be notionally fixed and prices adjusted purely by the CPI-X adjustment. The reason given for maintaining a fixed annual adjustment is to provide stability of prices. Allowing prices to change due to movements in interest rates detracts from this argument and therefore the implications need to be assessed more widely.

The draft decision does not explain why allowing this flexibility will add to the achievement of the NEO/NGO. Certainly, it will transfer risk from the NSP to consumers and, as the AEMC notes, if prices were able to be adjusted in line with movements in interest rates, this would reduce the risk profile of the regulated firm and require other adjustments to be made in the rate of return.

Allowing variation in annual prices to reflect changing interest rates seems to be an unusual step and does not seem to reflect the way debt is acquired in the most efficient way. It is clear that a firm accesses debt on a portfolio basis with differing amounts, start dates, terms, sources and interest rates. With such a mix of differing debt acquisition, the MEU has difficulty in identifying how allowing changes in interest rates during a regulatory period will assist the regulator in establishing an efficient debt provision strategy for the benchmark provider.

On balance, bearing in mind the potential that allowing prices to move as a result of interest rate changes provides the regulated firm an incentive to game the interest market, the MEU does not consider that the proposal to incorporate an adjustment in revenue for interest rate changes assists in the achievement of the NEO/NGO as it increases the risks for consumers, opens up the potential for gaming and does not reflect the actuality of how debt is in practice acquired.

2.4 Averaging periods

The draft rules provide considerable flexibility available to regulated firms to change the averaging periods used to identify forward looking estimates of debt and equity.

The MEU recognises that averaging periods have a considerable impact on the actual values used in the development of the rate of return. For example, the recent low returns for Commonwealth bonds has resulted in significantly lower rates of return of regulated firms than seen in the past. Averaging the current risk free rate over a longer historical basis would result in the risk free rate being considerably higher than if it was averaged over a few weeks or months as current bond rates are near 50% of the long term average bond rate.

The MEU does not have a fixed view as to what should be the averaging period for setting the rate of return, other than whatever is decided, needs to be consistent and not be changed frequently. As with other rate of return elements, allowing excessive freedom for regulated firms to frequently change averaging periods provides the basis for gaming and opting for the outcome that provides the maximum revenue stream for the regulated firm.

As the regulatory regime is based on incentives to ultimately deliver the least cost to consumers in the long term, providing flexibility for the regulated firms to maximise allowed revenue by varying the bases on which the rate of return is calculated, does not meet the intent of the NEO/NGO.

3. Capex and Opex allowances and factors

Overall, the AEMC assessment of the capex and opex allowances and factors provides a sound basis to implement the various changes seen as required to make the task of the regulator more robust and to allow it to ensure that the allowances for opex and capex are efficient.

The MEU agrees with the AEMC that:-

- There are areas for improvement in the NER to clarify the approach and to remove ambiguities that constrains the AER

- Benchmarking is critical in assessing the efficiency of a NSPs capex and opex forecasts, and that it takes account of differences in the environment of difference NSPs.

- Annual benchmarking of NSPs by the AER should be implemented

- Methodologies for determining explanative forecasts should be set in advance of the NSP preparing its regulatory proposal and included as part of the framework and approach paper.

The MEU notes (and welcomes) the following assessment by the AEMC, viz.:-

> ”For example, the obligation to accept a reasonable proposal should reflect the AER's current practice. There is no reference to a reasonable range, which is appropriate. The AER, whenever it determines a substitute for a NSP's proposal, is not constrained by the capex and opex criteria from choosing the best substitute it can determine. As described above, the criteria also do not impose an inappropriate evidentiary burden.” (AEMC Draft Rule Determination Paper, Page 104)

The MEU considers that this decision by the AEMC will greatly assist the AER in setting efficient allowances for opex and capex

4. Capex incentives

The AEMC comments that it:

> "… does not agree that capex incentives in the NER provide incentives for NSPs to spend more than their allowance." (AEMC Draft Rule Determination Paper, Page 116)

The AEMC goes on to comment that it does see that a difference between the allowed cost of capital and the actual cost of capital an NSP might incur provides the basis to support an overspend. The MEU considers that the AEMC commentary reflects a basic lack of understanding of how capex is controlled in the "real" world. For the AEMC to discount the fact that a network secures the bulk of its profit from the RAB*WACC element of the building block and that this is a core driver for network asset growth, is most concerning and inconsistent with AEMC commentaries in other aspects of the rules[4].

Relating to this issue, the MEU sought direct feedback from its members as to how each of them raises funds for capital works, allocates and then controls capex and assesses performance after the event. When comparing the way MEU member companies manage capex and how regulated firms do so, the MEU noted that the privately owned networks tended to more closely follow the approaches and controls used by MEU members but the state owned corporations tended not to. The main difference between MEU members approach and that of privately owned networks was that the Rules currently allow the automatic roll in of actual capex, regardless as to whether such capex was efficient.

The MEU identified that the reasons for this were that privately owned firms are relatively constrained in the amount of capital they were able to secure, being held to retained earnings and borrowings – generally such firms are loath to seek new equity by issuing new shares as this dilutes the returns existing shareholders receive. In contrast, state owned networks are able to raise considerable amount of capital from their related finance corporations, usually at costs less than those faced by privately owned networks.

4.1 Efficient capex

The AEMC assumes that the ex ante allowance granted for capex will be efficient and that, therefore, if actual capex is the same (or less than the allowance) then the capex actually used is efficient and can be added to the asset base. This is indeed a bold assumption.

---

[4] For example, the Rules are structured to minimise network solutions by ensuring that non-network solutions to augmentations and/or reliability can be compared equitably. This point is clearly made in the RIT-T assessments. If there was no incentive to create network solutions in preference to non-network solutions, then such controls as there are to ensure equitable comparisons are made would not be necessary.

The AEMC fails to address the view that once the ex ante capex allowance is set, there is no requirement that the NSP actually use the ex ante allowance for the projects that the allowance was built up from. In discussions with the LMR Expert Panel, it was noted that the regulatory allowance is merely a "bucket of money" that the service provider is allowed to recover through its pricing approach – what it does with the money thereafter is its own business. When viewed from this aspect, it is quite clear that the ex ante capex allowance does not, of itself, mean that this represents efficient use of capital.

The AEMC does require that the AER should assess previous capex by carrying out a review of the historic capex, but implicitly, even if the regulator identifies that some of the actual capex was not efficient, it is powerless to address this. At most, it might make the regulator a little more alert to future claims for capex by the NSP. Either way, consumers will incur a penalty because the capex was not efficient and has increased costs (and prices) unnecessarily for the life of the asset.

The AEMC provides no guidance as to how the AER is to use its knowledge that capex incurred was inefficient. In fact the AER has little scope to use the knowledge, as it must assess future allowances on the basis that the capex it allows for is efficient, but there is still no restraint on the network to use the capex as was intended when the allowance was developed.

One of the greatest concerns the MEU has with capex incentives, is that the network under-costs a network option as part of a RIT assessment, and then overspends. Consumers lose in two ways – firstly that the most efficient approach was not implemented and secondly the network is then incentivised to reduce other capex so as to avoid a capex over-run. The AEMC draft rules will allow the deferred capex to be included in the next regulatory period.

The MEU notes that AEMC consultant (Parsons Brinckerhoff) comments that overspends are more likely when there is insufficient regulatory oversight as this strengthens the potential for overspends due to a lack of consequences (AEMC Draft Rule Determination Paper, Page 123). That only overspends are more likely with minimal oversight misses the point that any inefficient capex is more likely the less the oversight provided.

The MEU considers that PB makes a valid point, if somewhat truncated, and that is why the MEU has consistently sought for there to be the ability for an ex post audit of capex to determine how much capex should be rolled into the asset base.

The AEMC proposes that if, and only if, the ex ante capex allowance is exceeded, should the regulator have the power to carry out an ex post audit of the amount of the over-run, with the potential that some of the over-run might not be allowed into the asset base. This creates two significant problems.

1. There is a challenge for the regulator to assess which projects caused the over-run as this is the only element that the regulator is able to investigate.

2. The MEU notes that large augmentation capex programs are required to satisfy a regulatory investment test to ensure that the lowest cost option (ie most efficient investment) is implemented. Once completed, providing there is a net benefit, the investment proceeds. This is the point at which an ex ante capex assessment ceases, as the investment, based on the capex assumed for the project, is seen as efficient. Should the project incur higher costs than that used to substantiate the investment, unless the ex ante capex allowance is exceeded, there will be no investigation or resultant penalty. In fact based on the RIT another approach could well have been more efficient than the project actually implemented.

The MEU notes that regardless of whether the regulator actually implements ex post audits and adjustments, it is the potential that such an adjustment might occur which provides the discipline to ensure costs are constrained.

The AEMC observes that an ex post review of the efficiency of past capex will provide incentives to ensure capex is efficient as inefficient capex might cause the capex allowance to be exceeded. While an ex post review is better than no review, there remans the risk for consumers that the ex ante allowance was always too high and that the ex ante allowance is not exceeded even though the regulator identifies that some capex was not efficient.

The AEMC in its decision to only allow an ex post adjustment for inefficient capex if the ex ante allowance is exceeded, is inconsistent with the regulatory approach in the gas rules, where the regulator is required to only include capex in the asset base that is prudent capex. The explanation provided by the AEMC for not requiring a full ex post adjustment is that this would impose increase regulatory risk for electricity networks, yet there is not such a concern expressed for gas networks. Furthermore, there is also the question of increased risk and costs to consumers. The MEU strongly urges the AEMC not to waste this current opportunity to ensure that network investments are efficient.

4.2 Incentive capex sharing scheme principles

The AEMC posits that the regulator is to develop a capex incentive sharing scheme and then provides three principles that the scheme must embody. These are:

1. It must reward efficient capex and penalise inefficient capex
2. The scheme should not be mathematically symmetrical
3. No penalties apply when capex is efficient

The MEU has some concerns with the essential premise about these principles.

Firstly, consumers have an expectation that capex will be efficient. This impacts the first two points – why should there be a reward for doing the job that the NSP has been paid for and will get a return of both the capital used and a return on the capital used. There is already a reward embedded in the structure of the regulatory approach. To add an additional reward for doing what is expected, is “double counting”. Additionally, if there is already a reward for doing the job properly, why should there be any symmetry at all – inefficient capex needs to be penalised.

The second issue that MEU has with these principles, is that there is an incentive to invest inefficiently as, provided the ex ante allowance is not exceeded, the actual inefficient capex will be rolled into the asset base and the NSP allowed to recover both the excessive capital and receive a return on it as well.

This means that the principles proposed by the AEMC do not reflect the fact that there the NSP is already being rewarded for efficient investment and what the incentive program needs to do is really to ensure that the NSP minimises inefficiency.

The MEU considers that the principles need to be re-addressed to achieve the targeted outcome

4.3 Capex timing

The AEMC highlights that there is a tendency for NSPs to defer capex to be later in the regulatory period than was planned. The AEMC implies that such a deferral is in the interests of consumers as this reflects better use of capital. In practice, this is not the case.

What actually occurs is that the capex is often deferred within the regulatory period. By doing this the NSP is able to recover capital and get a return on capital that it has not invested because the allowed revenue recovery is based on the timing of capital investment as part of the ex ante allowance. Underspending capital in the early part of a regulatory period compared to the assumptions built into the regulatory decision provides a considerable benefit to the NSP which is not shared at all with consumers, even if the capex in the last years exceeds the allowances. Essentially, deferral of capex is not symmetrical as deferral is more likely to occur than for capex to occur early.

Even if capex is deferred across regulatory periods, consumers still are unlikely to benefit by the deferral. If capex was assumed to occur in one regulatory period, consumers are paying for the return of and on the capex assumed to occur. If it does not occur in the regulatory period but is deferred into the next period, consumers will still pay for the same capex in the next period as the NSP will include the deferred project in the allowance for that period.

The approach proposed that in each year the regulator would assess the overspend and use this to assess capex efficiency with the potential for adjusting the amount of the overspend does not recognise that efficient capex could well occur in the later years, even if there is an overspend, because the capex has been deferred from earlier years.

The MEU considers that the capex incentive principles and the capex overspend controls do not provide any protection for consumers from the NSP “gaming” the capex program and gaining a considerable benefit by deferring capex to later in the regulatory period. The obverse is that consumers faced increased risk.

The MEU is concerned that the capex incentive principles developed and to be imposed on the regulator will not achieve the outcomes that the AEMC is seeking.

4.4 Related party margins and capitalisation

The MEU agrees that the regulator should have the unilateral power to remove from any capex allowance a related party margin and any capitalised amount that it considers to be inefficient.

4.5 Summary of MEU views

The MEU agrees with the AEMC’s draft decision to:

> ”… to provide the AER with a number of "tools" which it can apply as it considers necessary to provide adequate incentives for NSPs to spend capex efficiently, having regard to an overall capex objective which is consistent with the NEO and RPP. These tools are:
>
> - capex sharing schemes to be designed by the AER;
> - efficiency reviews of past capex, including the ability to preclude inefficient expenditure from being rolled into the RAB. However, any exclusion will be limited to an amount that is equal to the amount of expenditure above the allowance; and
> - deciding whether to depreciate the RAB using actual or forecast expenditure to establish a NSP's opening RAB.” (AEMC Draft Rule Determination Paper, Page 116)

However, the MEU considers that the principles regarding the capex incentive scheme need to be examined and changed to reflect the concerns that the MEU has identified in the above sections 4.1, 4.2 and 4.3.

With these concerns the MEU remains firmly of the view that the AEMC proposals will not provide a more effective tool for ensuring capex is efficient and therefore deliver an outcome for consumers which meets the NEO because the way capex is used has an inbuilt bias towards benefiting the NSP. The MEU considers that a better solution is for the regulator to have the power to undertake an ex post audit of any capex project and to adjust the amount of capex that is rolled into the asset base.

5. Regulatory determination process and diverse issues

5.1 The regulatory process

The AEMC has provided detailed review of the processes involved in a regulatory review and has proposed a series of additional requirements aimed at improving the quality of regulation and the ability of stakeholders to provide useful input into the review processes.

The MEU agrees with the AEMC that the following additional requirements will improve the regulatory processes:

- "the NSP providing a consumer-targeted overview paper with its regulatory proposal;

- the AER publishing an issues paper outlining its preliminary key issues to assist the consumers to focus their resources; and

- the AER holding a public forum to allow consumers and other stakeholders to engage with the AER and NSP on the regulatory proposal and issues paper

- requiring the NSP to identify to the AER specific confidentiality claims in its regulatory proposal;

- requiring the AER to report such confidentiality claims on its website; and

- requiring the AER to report on its website where it receives late or out-of-scope material from the NSP

- extending the timeframe for the regulatory determination process by commencing it six months earlier;

- increasing the time for the NSP to prepare its revised regulatory proposal; and

- introducing a discretionary cross-submissions stage to target specific issues arising from submissions on the draft regulatory determination or revised regulatory proposal

- making the paper optional on particular matters that has been addressed in a previous framework and approach paper; and

- clarifying and aligning the circumstances for changing the service classification and formulaic expression of the control mechanism for unforeseen circumstances" (AEMC Draft Rule Determination Paper, Pages 153 and 154)

The MEU considers that all of these proposals will improve the quality of the regulatory outcomes and provide consumers with a greater ability to be active in the review process.

Whilst the issue of resourcing is not one for the AEMC's review, the MEU is particularly concerned that the AER must be adequately resourced in order for it to be able to deal efficiently and effectively with the additional process requirements arising from the AEMC's draft decision.

Resourcing of consumer advocacy groups is also critical, especially in light of the additional processes e.g. cross submissions, the framework and approach paper. In this regard the MEU notes that the Consumer Advocacy Panel budget proposed for 2013/14 does not include additional funding that will be needed to address the additional work that the changed regulatory processes will entail.

5.2 Diverse Issues

The AEMC proposes that there be greater commonality between the rules for electricity distribution and transmission. The MEU agrees that this is appropriate and will make the regulatory processes easier to implement.

The issue of shared assets being used for other purposes and thereby earning additional revenue for the regulated firm has long been a vexed issue. At its basis, if assets are effectively fully funded by consumers then any additional revenue that is earned should accrue to the benefit of those that provide the funding. The draft rule proposes that such a commercial benefit should be recognised and the MEU supports the new approach implemented.

The AEMC also proposes that the regulator will be permitted to implement trial incentive schemes in order to identify if such schemes can assist in better achievement of the NEO. Such a tool has been used by jurisdictional regulators in the pasts and the MEU supports that the AER have a similar ability.