

Response to the Exposure Draft of the National Electricity Rules

Submission to the Ministerial Council on Energy
Standing Committee of Officials

May 2007



1. Introduction

ActewAGL is a multi-utility company combining energy distribution and retail operations with interests in water services management and telecommunications. The ActewAGL Distribution partnership operates as a unique public-private joint venture between Alinta Limited and the ACT Government owned ACTEW Corporation. The ActewAGL Distribution partnership owns and operates the electricity distribution network in the ACT and the gas distribution networks in the ACT, Queanbeyan and Nowra.

ActewAGL welcomes the opportunity to respond to the exposure draft of the National Electricity Rules (draft distribution Rules). As the owner of one of the first distribution businesses scheduled for review by the Australian Energy Regulator (AER), ActewAGL is particularly keen to see progress in the establishment of the new national regulatory framework. The release of the draft distribution Rules is a critical step in the development of the new framework.

In line with the Ministerial Council on Energy (MCE) intention to achieve consistency in the treatment of transmission and distribution, the draft distribution Rules are largely based on the transmission Rules already developed by the Australian Energy Market Commission (AEMC), with some important differences to reflect the different characteristics of transmission and distribution networks and businesses. ActewAGL welcomes the additional flexibility in the draft distribution Rules, compared with the transmission Rules – for example, by not prescribing the form of regulation or the parameters for determining the cost of capital. However, the approach taken in the draft distribution Rules raises several concerns about regulatory discretion and accountability, and creates additional regulatory risk for businesses. ActewAGL's concerns are set out in sections 2 to 6 below.

ActewAGL is pleased that the Standing Committee of Officials (SCO) of the MCE has explicitly addressed the need for transitional arrangements for the pending ACT and NSW electricity distribution network price reviews. As SCO notes in the explanatory material released with the draft distribution Rules, the AER, regulated businesses, users and consumers require certainty about the regulatory framework that will apply and the procedure to be followed in making the reset decisions¹. Clear and agreed transitional arrangements with realistic time frames need to be in place as soon as possible.

SCO outlines one possible approach to transitional arrangements in the explanatory material². ActewAGL notes that in many respects the proposed transitional arrangements are the same as those in the draft distribution Rules. This approach should encourage consistency over time and ensure that significantly different rules do not apply to the initial reviews and subsequent reviews.

¹ SCO 2007, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution: explanatory material*, April, p. 42

²op cit, p. 42

However, given the limited time available until the ACT and NSW Distribution Network Service Providers (DNSPs) are expected to submit their pricing proposals to the AER (likely April 2008), it will simply not be possible to apply some aspects of the draft distribution Rules. For example, the draft distribution Rules requires the AER to develop detailed guidelines covering a range of matters, allowing for 80 days of consultation and publication at least two months before submissions are lodged. While this seems like a reasonable procedure for the new distribution Rules, it will clearly not be feasible for the upcoming ACT and NSW determinations.

ActewAGL believes that it is important that transitional arrangements adopted for reasons of time constraints should not create a precedent for the new National Electricity Rules. For example, while a pragmatic and heavily streamlined approach will be required to determining the form of regulation and form of price control for the ACT and NSW determinations, it is important that the new NER allows adequate time for review, consultation and notification of the AER's decision, well before submissions are due. In general, some things that may be appropriate as a transitional arrangement (for example, agreed treatment of WACC parameters) will not necessarily be an appropriate part of the permanent regulatory framework.

ActewAGL's comments on the proposed transitional arrangements are set out in section 7 below.

2. The cost of capital

A key area where the draft distribution rules depart from the transmission rules is in the treatment of the cost of capital. The initial distribution Rules will leave the value of WACC parameters to the discretion of the AER, in contrast to the transmission Rules which specify the value of critical WACC parameters.

ActewAGL has serious concerns about the approach taken in the draft distribution Rules. While we agree that it is appropriate for a more flexible approach to be adopted for distribution, compared with transmission, the approach taken involves greater discretion for the regulator and greater uncertainty for businesses, which are not balanced by adequate accountability and review provisions.

Under clause 6.5.2(f) of the draft distribution Rules, the AER is required to initiate a review of cost of capital parameters in July 2009, and every five years thereafter. However, under clause 6.5.2(h) it has discretion over whether it applies the parameter values determined in the industry-wide review. This creates unreasonable uncertainty for businesses.

If the AER chooses not to use the industry-wide parameters set in the five-yearly review, and instead sets them as part of an individual determination, then it is assumed that the parameters will be subject to appeal and review. ActewAGL believes that this scope for appeal and review is essential to ensure that errors are not made in this critical element of the determination.

ActewAGL believes that it is not appropriate to apply a common set of WACC parameters across all distribution businesses, given that the distribution businesses face different regulatory and operating environments. The serious problems with this approach would be exacerbated if businesses were not able to appeal against the application of the industry-wide parameters, as is understood to be intended.

ActewAGL believes that the distribution Rules should require the cost of capital to be set separately as part of each network pricing determination, and therefore subject to review and appeal provisions.

3. Regulatory process

Another key way in which the draft distribution Rules depart from the transmission Rules is in the classification of services and the determination of how they will be regulated. ActewAGL agrees that the greater diversity in the type of services and market conditions for distribution mean that it is not appropriate for the distribution Rules to prescribe the form of regulation and the form of price control.

However, ActewAGL does not support the proposed process through which key decisions on the form of regulation and form of price control will be made. Under clause 6.8.2 of the draft distribution Rules, the DNSP must submit its full regulatory proposal, including the proposed classification of services and proposed form of price control, 13 months before the start of the new regulatory period. The AER is then required to publish its draft decision within 6 months of receiving the proposal.

If the AER does not accept the proposed classification of services and price control methods, the DNSP would face the unreasonable burden of having to prepare a new proposal, based on the AER's required classification, in the impossibly short time of 30 days.

ActewAGL believes that the proposed one-step process for submitting all aspects of the DNSP's proposal should be replaced by a process whereby the DNSP submits any proposed changes to the classification of services and associated price control methods 2 years before the new regulatory period, and the AER then makes a binding decision on the proposal leaving sufficient time for the DNSP to then prepare the revenue and pricing proposal 13 months ahead of the next regulatory period.

ActewAGL notes that this alternative two-step process will clearly not be feasible for the upcoming ACT and NSW reviews, so one-off transitional arrangements will be necessary, as discussed in section 7 below.

A further problem with the proposed process is that it allows only 30 days for the DNSP to re-submit a regulatory proposal if required by the AER. While the two-step proposal outlined above should reduce some of the risk that the proposal will need to be significantly revised, it is still possible that substantial and complex changes will be required. ActewAGL believes that

the time allowed for re-submission of a proposal, where required, should be extended to 60 days.

4. *Guidance for AER decision-making*

A further key difference between the draft distribution Rules and the transmission Rules is in the guidance each provides for the AER's decision-making. ActewAGL is concerned that the approach taken in the draft distribution Rules does not effectively implement the 'fit-for-purpose' approach committed to by the MCE and already embodied in the transmission Rules. Under the fit-for-purpose approach, the AER has considerable discretion to determine outcomes for some aspects of the review, while in others it must accept the DNSP's proposals provided they meet certain criteria or requirements.

In the transmission Rules, clause 6A.14.3 sets out the 'circumstances in which matters must be approved'. While the draft distribution Rules adopt some elements of the transmission approach – most importantly the requirement that the DNSP's proposed operating and capital expenditure forecasts be accepted if they meet certain requirements – they do not contain an equivalent to clause 6A.14.3.

Failure of the draft distribution Rules to adequately set out the circumstances in which matters must be approved or accepted means that DNSPs face uncertainty about how their regulatory proposals will be assessed and the weight that will be given to their proposals.

5. *Service performance incentives*

The draft distribution Rules require the AER to develop and publish a service standard incentive scheme, following procedures and principles largely based on those in the transmission Rules. ActewAGL believes that there are some significant problems with the proposed approach.

While clause 6.6.2 of the draft distribution Rules provides scope for the AER to specify different parameters for different DNSPs and over time, a single scheme will apply to all DNSPs. The adoption of a single service performance incentive scheme is clearly inappropriate, given the vast differences in network and market characteristics across DNSPs, substantially different current regulatory frameworks and different reporting and monitoring requirements.

A further fundamental problem with the service incentive scheme provisions in the draft distribution Rules is that they fail to recognise the critical role that consumers should play in setting appropriate standards for their service providers. Clause 6.6.2 sets out factors that the AER must take into account when developing its scheme. Consumers' willingness to pay is a notable omission. We note that in January this year, SCO released a document that set out its

proposed approach to the distribution Rules³. This document explicitly referred to the need to take account of customers' willingness to pay. ActewAGL believes that the draft distribution Rules must reflect this position.

The approach to service standards in the distribution Rules should also recognise that the DNSPs are best placed to identify and respond to the needs of their customers. They have the incentive and the information to identify price and service offers that best meet the needs of customers, within the framework provided by current jurisdictional service standard policies. We therefore believe that the AER should be required to develop any service incentive scheme with reference to the service standard proposals of the DNSPs, which should be submitted as part of the revenue and pricing proposal.

6. Network tariff pricing principles

ActewAGL supports the broad approach to tariff setting adopted in the draft distribution Rules. This involves setting pricing principles that are at a sufficiently high level to allow for the various operating contexts of different DNSPs across Australia and are not overly prescriptive⁴.

ActewAGL is concerned, however, that the principles contain a fixed side constraint to apply to tariff increases for standard control services. We appreciate that the constraint proposed by SCO in the explanatory document released in January 2007 has been relaxed to some extent, with some limitations on when it will apply⁵. However, ActewAGL believes that the constraint should be removed altogether, or at least relaxed further, given the likely negative impacts on tariff reform and rebalancing. We note that no side constraints have applied under the Independent Competition and Regulatory Commission's past and current determinations for ActewAGL's electricity distribution network, and can see no compelling case why a side constraint should now be applied to all DNSPs.

7. Transitional arrangements for the ACT and NSW 2009 determinations

In the explanatory material released with the draft distribution Rules, SCO outlines a possible approach for the ACT and NSW transitional arrangements⁶. SCO's stated preference is to deal with the transitional arrangements via chapter 11 of the National Electricity Rules (NER). SCO says that it is considering other options in case of possible delays to the NER. ActewAGL

³ SCO 2007, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution: explanatory material*, April, p. 34

⁴ NERA 2006, *Distribution Pricing Rules Framework, Report for Network Policy Working Group*, December, p. 4

⁵ SCO 2007, *op cit*, p. 31

⁶ SCO 2007, *op cit*, p. 42

believes that it is important that SCO outline all options and its preferred approach as soon as possible, in order to reduce the uncertainty facing the ACT and NSW DNSPs.

ActewAGL fully supports the proposed transitional approach to the form of regulation, price control method and form of price control. Maintaining the current classification of services (albeit with different terminology) and applying the same form of price control as is currently applied is clearly a pragmatic approach given the limited time before the DNSPs must submit their regulatory proposals. Our only concern with the proposed approach is that the form of price control for alternative control services (previously known as excluded services) will be left to the AER's discretion. ActewAGL urges the AER to make a decision on the form of price control as soon as possible, to allow the decision to be reflected in ActewAGL's April 2008 regulatory proposal. ActewAGL's preference is that the current approach be continued throughout the next regulatory period.

SCO proposes that the processes and requirements for revenue and pricing proposals in the draft distribution Rules would apply for the transitional arrangements. As noted in section 3 above, ActewAGL believes that this process should be amended, to allow 60 days for the DNSP to re-submit a proposal if requested by the AER.

ActewAGL supports the proposed transitional approach to the treatment of the opening regulatory asset base. It is appropriate to include 2004-2009 capital expenditure that would have been eligible under the jurisdictional regulators' criteria and to calculate depreciation on the same basis that the jurisdictional regulators would have applied. Retrospectively changing the treatment of capital expenditure and depreciation would create unacceptable regulatory risk. ActewAGL also fully supports the proposal that the AER will need to make any other adjustments to the regulatory asset base that the jurisdictional regulators have envisaged in their determinations, policies or guidelines. ActewAGL asks that, in addition, the transitional arrangements commit the AER to accommodate intentions formally expressed by the jurisdictional regulators *during* the period, for example, in respect of current period capex. Such a provision would serve to further reduce uncertainty for the distributors during the transition period.

While ActewAGL believes that it is not appropriate for the distribution Rules to allow WACC parameters to be set before a determination process starts, with no recourse to appeal (as discussed in section 3 above), we do accept that for the transitional arrangements it will be pragmatic to adopt the transmission parameters. ActewAGL stresses that this approach should not create a precedent for future reviews. ActewAGL also fully supports SCO's position that the WACC parameters should remain unchanged throughout the review, and not be changed in response to the findings of the five-yearly reviews. Changing them during the review would be totally inconsistent with the MCE's intention of creating a stable and predictable regulatory framework.

ActewAGL also supports the proposed transitional approach to the other building block components. In relation to cost pass-throughs, we agree that if new ring fencing guidelines impose additional compliance costs on the DNSPs then these costs should be recovered as a cost pass-through. However the potential complexities of such an arrangement should not be

underestimated. Our preferred approach is that the current arrangements stay in place for the duration of the next determination, to reduce the uncertainty facing the DNSPs.

In relation to incentive schemes, SCO proposes that the draft distribution Rules would apply⁷. ActewAGL's concerns about the draft provisions covering service incentive schemes are outlined in section 5 above. Timing is an additional issue for the ACT and NSW reviews. ActewAGL believes that it will not be feasible for the AER to develop a scheme before the ACT and NSW reviews, and it is not reasonable to introduce a new scheme part-way through the next regulatory period.

Efficiency benefits schemes are also to be developed and published by the AER, and SCO anticipates that the AER may now begin general consultation about the necessary guidelines⁸. ActewAGL is keen to participate in this process. The AER has indicated a preference to adopt the transmission approach to opex and capex incentives. ActewAGL believes that, as part of the consultation process, the potential implications of differences between transmission and distribution need to be fully explored and addressed.

In relation to pricing methodology, ActewAGL does not support the application of a side constraint, as outlined in section 6 above.

SCO identifies some transitional issues that will arise from the application of the proposed cost allocation guidelines for NSW. While ActewAGL currently has different cost allocation requirements to those set out by IPART, similar issues will be relevant in the ACT. The transitional approach adopted should be guided by the availability of historical data. ActewAGL supports the pragmatic approach of gradually requiring any move to new reporting requirements so that the new cost allocation guidelines can be fully implemented at the 2014 resets⁹. ActewAGL is keen to work with the AER to develop a practical and realistic transitional approach to cost allocation, as the NSW DNSPs have.

⁷ SCO 2007, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution: explanatory material*, April, p. 46.

⁸ SCO 2007, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution: explanatory material*, p. 47.

⁹ op cit, p. 48.

