

ELECTRICITY TRANSMISSION NETWORK owners

National Electricity Rules Distribution Revenue and Pricing Rules

Response to Exposure Draft

25 May 2007



Economic Regulatory Package – NER Distribution Revenue and Pricing Rules

Response to Exposure Draft

The Electricity Transmission Network Owners Forum (“ETNOF”)¹ welcomes the opportunity to comment on the Exposure Draft of the distribution revenue and pricing Rules.

As transmission network owners, ETNOF does not have a direct interest in the distribution Rules, apart from matters of regulatory principle that have the potential to establish precedents for transmission regulation. In this regard, the application of merits review within a ‘fit for purpose’ regulatory framework is an issue that is of particular interest to ETNOF.

In terms of policy direction, ETNOF supports the recommendation of the Expert Panel on Energy Access Pricing and the policy positions previously adopted by the MCE. In particular, the MCE accepted that the preferred regulatory decision model is ‘fit for purpose’ – which requires that there be an appropriate balance and allocation of ‘receive-determine’ and ‘propose-respond’ elements across the full range of matters that feature in a revenue proposal.

Guided Discretion and Access to Appeal

The extensive application of detailed criteria in the Rules is an important element in guiding regulatory discretion, whether that discretion resides with the service provider (propose-respond) or the AER (receive-determine). In ETNOF’s view, it is the absence of “guided discretion” that led to the unsatisfactory experience of regulation in the transmission sector prior to the establishment of the AER. ETNOF notes that the application of this “guided discretion” is yet to be tested.

An important adjunct to guided discretion is the ability of the service provider to challenge regulatory decisions where it is clear that the AER has made an error or acted unreasonably. As noted by the MCE and Expert Panel, limited merits review is an important feature of good regulation. Merits review not only provides the network service provider with recourse to an effective appeal mechanism – thereby providing some assurances to investors that regulatory decisions will be soundly based – but it also places a discipline on the regulator to deliver reasoned decisions based on the available evidence.

In relation to the cost of capital, ETNOF notes that regulatory error can have serious and material negative impacts on network investment. To put the criticality of this issue in context, the return on capital in a capital intensive industry such as electricity transmission usually comprises more than half of its allowable revenues. This means that relatively small changes in cost of capital parameters can have a significant impact on revenues and a business’ ability to not only attract, but to continue to access required investment funds to deliver the levels of reliability sought by users and mandated in regulatory instruments.

Both the Productivity Commission, in its review of the Gas Access Regime and, more recently, the Prime Minister’s Task Force on infrastructure bottlenecks, identified the need for regulator’s decisions on allowed returns to be made in a way that is likely to

¹ ETNOF members are: ElectraNet Pty Limited, Powerlink Queensland, SP AusNet, Transend Networks and TransGrid.

provide incentives for more, rather than less investment in infrastructure. In particular, the Productivity Commission highlighted that the scope for regulatory error, asymmetric risks and high potential costs to society as a whole from under-investment in national infrastructure far outweigh the detriment of (possibly) higher access prices.

ETNOF considers that it is also important to recognise the AER's powers of discretion in relation to adopting WACC parameter methodologies and values in both the electricity transmission revenue Rules and draft distribution revenue and pricing Rules. Clause 6A.6.2(h) of the electricity transmission revenue Rules provides an example of this. Under this provision the AER is not compelled to adopt revised values, methodologies or credit ratings arising from its five-yearly reviews. Extending this example further, ETNOF notes that the AER may also be selective in its adoption of any of these revised items.

Given the significance of regulatory returns to ensuring that adequate investment takes place, ETNOF believes that the discretion afforded the AER in respect of WACC decisions must be accompanied with the accountability of the decision being reviewable. The absence of such a mechanism has the potential to carry what might be considered an unreasonable decision by the AER not to adopt a particular outcome from a five-yearly WACC review for many years thereafter, once locked into a TNSP's revenue reset determination. ETNOF considers that this is the domain of public policy. The alternative of relying on an iterative Rules change process to achieve improved certainty is clearly inadequate for a revenue component as significant as WACC.

NEM Governance Framework and Implications for WACC Decision Making

ETNOF is also very concerned that the view among policy advisers appears to be that the AER's five-yearly WACC reviews are 'quasi legislative' decisions, and therefore not eligible for merits review. As this view has potentially significant implications for the current NEM Governance arrangements, ETNOF strongly encourages further close scrutiny of this line of argument.

The National Electricity Law (NEL) provides that the AEMC is the Rule making body and is the only body capable of making Rules that have the force of law. The AER is not a Rule making body and is not empowered to make Rules that have the force of law. ETNOF is concerned that if policy makers are working on the assumption that the AER can make 'quasi legislative' decisions, this is at odds with the principles established in the NEL. On this basis, a number of issues are raised.

Firstly, it is not clear what is meant by a 'quasi legislative' decision. ETNOF understands that this concept has no standing under the NEL, particularly in relation to the AER's powers.

Secondly, if such a concept had standing, it begs the question as to which body would now have the role of enforcement and compliance of such 'quasi legislative' decisions. ETNOF considers that it would clearly be inconsistent with the intended NEM arrangements involving proper 'separation of powers' for this function to remain with the AER.

Consideration of Options

One solution to this dilemma could be to make the AEMC responsible for conducting the five-yearly WACC reviews. This approach would ensure that outcomes of each

review would have the standing of a legislative decision and, in line with current thinking, remove such reviews from the reach of the proposed 'merits review' process. However, it would also ensure that these decisions are subjected to the AEMC Rule change consultation process, including statutory assessment against the National Electricity Market Objective.

Alternatively, the WACC reviews could be considered as a form of 'bundled' revenue cap decision by the AER. This appears to be similar in many regards to the AER conducting concurrent reviews of a number of transmission businesses, as happens now in the case of TransGrid, Transend, and Energy Australia's transmission services. This 'bundled review' approach retains the concept of certainty on these critical WACC parameters, as intended by the AEMC. It also minimises the extent to which the same issues are revisited by costly reviews at every successive revenue cap decisions.

Finally, subjecting these 'bundled' decisions to merits review would preserve key accountability drivers on the AER to ensure that processes for the conduct of these reviews are truly robust. Without merits review it is not clear how the accountability of the AER would be preserved in relation to one of the single most important elements in ensuring adequate levels of investment in electricity transmission. It is worth remembering that ETNOF members currently have assets in service with a current regulatory value in excess of \$9.1 billion, and intend on investing at least several billion dollars more over the next five years.

ETNOF considers that any concern that merits review would add complexity and cost to the process pale into insignificance compared with a return to the inclusion of WACC parameter decisions in individual revenue cap decisions. Under this latter arrangement every WACC review would be eligible for merits review.

Assuming that concerns remain that the five-yearly WACC parameter reviews constitute a form of legislative decision making, then they should remain with the AEMC rather than the AER.

Conclusion

Notwithstanding this, ETNOF encourages the Standing Committee of Officials to further consider whether there is a need to exclude any element of the regulatory revenue decision from merits review, in particular, decisions in relation to the cost of capital.

ETNOF strongly believes that continuation of the MCE's current position to exclude such a core building-block element of a revenue determination from merits based review would significantly weaken the accountability of the AER. This is particularly the case given the discretion available to the AER not to adopt revised values, methodologies and credit ratings for which persuasive evidence may have been provided following a WACC review and the significance of the cost of capital in terms of a TNSP's ability to attract and retain necessary funds for investment.