



10 April 2006

Ms Marie Taylor
Manager, MCE Secretariat
Department of Industry, Tourism and Resources
GPO Box 9839
Canberra ACT 2601

Dear Ms Taylor

MCE Expert Panel Draft Report on Energy Access Pricing – Additional Comments

The Energy Networks Association (ENA) wishes to thank the Ministerial Council on Energy (MCE) Expert Panel for the opportunity to meet the Panel for a consultation session on 6 April. This consultation meeting provided a useful means of highlighting aspects of the ENA's recent submission and achieving a better understanding of the Panel's considerations on several key issues.

With the benefit of the discussions at the consultation session, the ENA offers a number of additional comments to the Expert Panel on some of the important matters which the Panel is tasked with reporting on. These additional comments build on ENA's participation in the consultation session by providing further information on areas covered only briefly. The additional comments cover three areas:

- the 'propose-respond' regulatory model under the gas access regime
- the asymmetric risk of regulatory error and its significant consequences for mature energy distribution networks
- the need for access pricing principles to offer clear and meaningful guidance

Additional comments on these matters are set out below.

Propose-respond regulatory model in gas

The ENA is concerned to ensure that the Panel's considerations on alternative regulatory models are based on a full understanding of the operation of these models to date in gas and electricity.

The 'propose-respond' regulatory model currently operates under the gas access regime. Under this model regulated businesses initially put forward key elements of proposed access arrangements, including proposed capital expenditure programs, costs related to operating and maintenance and providing a return on existing assets, depreciation schedules, and detailed terms and conditions of access. The propose-respond model thus incorporates many more elements than simply the right of a regulated business to initially propose a cost of capital estimate for consideration by the regulator.

The AEMC's Chapter 6 review process has recently developed a 'limited' propose-respond model, where a regulated business may propose only certain elements of an access arrangement. Under the AEMC's draft rules a regulated business can propose operating and capital expenditure forecasts, and depreciation allowances. The draft rules, however, prescribe key parameter values and methodologies in relation to estimates of the cost of capital used to establish appropriate returns on existing assets. The propose-respond model which has operated under the gas regime since 1998 does not feature limitations of the type proposed by the AEMC.

Importantly, a propose-respond model is compatible with an approach where key cost of capital values and methodologies are prescribed in energy rules or determined on a periodic basis by a regulator accountable through a system of effective merits review. However, a propose-respond model can also be workable and effective where such prescription around cost of capital estimates does not exist, as the operation of the gas regime to date demonstrates.

The gas access regime is the only nationally consistent and certified energy access regime operating to date in Australia. Regulatory price reviews under the gas regime have been more timely (taking on average 12 months) than those under the 'consider-decide' model in place in electricity distribution (average 19 months). Empirical evidence from the record of network pricing determinations made since 1998 also demonstrates that there has been no upward bias in cost of capital estimates produced by the propose-respond model. In contrast to the gas regime, the consider-decide electricity model contains no structural incentives for regulated businesses to submit initial cost of capital estimates that meet a regulator's view of an appropriate benchmark cost of capital. Under the gas regime regulated businesses whose estimates for an appropriate cost of capital fall outside of a range considered as reasonable by the regulator face the prospect of a regulator being empowered to reject and entirely 'rewrite' this part of a proposed Access Arrangement.

Due to these considerations, the ENA believes that the Panel should recommend in favour of retaining the propose-respond approach in gas, and recommend its implementation in electricity, consistent with the approach of the Western Australian government in recently introducing its WA Electricity Network Access Code.

Risk of regulatory errors for mature energy networks

The ENA wishes to question the assumption underpinning key recommendations of the Draft Report that there may not be an asymmetric risk of regulatory error in relation to infrastructure access pricing, or that this risk may not be significant for existing energy infrastructure assets.

The Draft Report heavily focuses on the risk of regulatory error with respect to greenfield investments, highlighting the potential for demand uncertainty to negatively impact on regulatory and commercial outcomes. Energy network businesses with significant sunk assets, however, also face considerable uncertainty regarding future demand levels and patterns. In this regard, demand increases which were outside of the range of developed forecasts played a significant role in events leading to the Somerville report in Queensland. Similarly, IPART has recognised through its most recent pricing decisions that systematic underinvestment took place in relation to New South Wales electricity distribution networks in the period 1999 to 2004 resulting from a failure to predict demand outcomes.

Mature energy networks provide almost every Australian household and business with energy services. Asymmetric impacts of regulatory errors and under investment relating to the existing \$35 billion of energy network infrastructure clearly have a far greater capacity to affect the interests of the community than failures of specific commercial greenfield investments.

In this context it is noted that neither the Prime Minister's Infrastructure Taskforce nor the Productivity Commission's reviews of gas and national access regimes concluded that regulatory error is a lesser risk for existing infrastructure assets than for greenfield assets. The national access regime has recognised the need to protect against the asymmetric risk of regulatory error on existing assets through inclusion of a requirement for regulated access charges to provide expected revenue which is '*at least sufficient*' to meet expected costs, and through the specific recognition of the need for charges to take into account regulatory as well as ordinary commercial risks.

The ENA recommends that the Final Report fully recognises the significant potential impact of regulatory error on existing, and not just new energy network assets. The Final Report should also ensure that future pricing provisions of energy access regimes specifically reference the concept of regulatory risk, and closely reflect the agreed pricing provisions of the national access regime.

Pricing principles and uncertainty of proposed guidance for pricing rules

The ENA has significant remaining concerns relating to the adequacy of basing future energy access pricing rule-making on a modified version of Section 35 of the *National Electricity Law*. Key areas of Section 35, such as the provision that access prices provide a '*reasonable opportunity*' to recover efficient costs, give little certainty to existing or potential investors.

It is unclear, for example, whether a regulatory decision which provided an energy network business with *some* prospect of recovering the total revenue assessed as required, but where the more *likely* outcome was an under recovery of costs, would be viewed as offering a '*reasonable opportunity*' in this context. A wide range of potential energy access pricing rules may offer some prospect of recovering efficient costs, whilst still being so uncertain as to potentially deter significant ongoing investment in existing assets. The concerns of energy network businesses about uncertainty over the meaning and effect of key terms in Section 35 are heightened by the fact that no significant consultation was undertaken in relation to these provisions of the *National Electricity Law*.

The Panel proposes inclusion of additional principles drawing the AER's attention to the risks and costs of over and under investment, and the over and under utilisation of assets. This form of guidance, which lists four conflicting factors for consideration and reconciliation by the AER, does not provide any direction on the weight to be assigned to the risks identified. In particular, it fails to highlight the manifestly negative impact that over utilisation of, and under investment in, network infrastructure may have on energy network customers. The Draft Report itself elsewhere notes:

By giving discretion to the regulator to balance the objectives where they conflict, uncertainty in their application is created.¹


¹ MCE Expert Panel *Draft Report to the Ministerial Council on Energy*, March 2006, p.97

A major theme of recent reviews of the gas and national access regimes has been the identification and removal of so-called 'laundry list' provisions containing multiple conflicting objectives, and their replacement by clearer and more certain guidance to regulators. This approach was also taken by the MCE in its recent reformulation of the National Electricity Market objective, which previously had multiple conflicting sub-provisions.

The ENA recommends these provisions be revised to explicitly give guidance to the AER to assign special weight in their decision-making to the risks and costs to the community of under-investment in, and over utilisation of network assets.

Please feel free to contact me on (02) 6272 1519 if you have any queries relating to this letter, or wish to discuss any of the issues raised in this letter further.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Garth Crawford', enclosed in a thin black rectangular border.

Garth Crawford
National Director – Government and Regulatory Affairs
Energy Networks Association