energy networks association

Response to NSW Independent Pricing and Regulatory Tribunal—Draft report—Changes in regulated electricity retail prices from 1 July 2011

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1. Overview

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART's) *Draft Report—Changes in regulated retail electricity prices from 1 July 2011* (Draft Report).

The Draft Report proposes increases in regulated electricity prices effective from July 2011, and examines the range of factors which are currently driving increased electricity prices in New South Wales. The Draft Report also goes beyond an assessment of permitted increases in regulated retail charges to make a number of recommendations on the national regulatory policy framework governing electricity network charges, recommending a review of these arrangements to address four specifically claimed deficiencies in areas of Chapters 6 and 6A of the *National Electricity Rules* (NER).

These four claimed areas of deficiencies cover the 'burden of proof' facing the Australian Energy Regulator (AER) in making determinations on network cost forecasts, the design of merit appeal processes, the degree of regulatory guidance in setting regulated returns and the 'ex ante' capital expenditure approach adopted in the NER.

Energy network businesses are concerned that significant elements of IPART's assessment of these aspects of the NER and the broader regulatory framework appear to not to be based on sound analysis. In particular, several assumptions made in the analysis in the Draft Report do not to take into account critical provisions of the *National Electricity Law* and *National Electricity Rules* which are directly relevant to the issues discussed by IPART. In addition, several criticisms made of the regulatory regime also do not accord with evidence from the actual experience of the application of the NER by the AER.

Energy network businesses also consider that the conclusions in the IPART Draft Report do not adequately reflect the full range of regulatory and public policy considerations which have led to the deliberate design choices recently made by Australian governments and the Australian Energy Market Commission in the modernisation of the *National Electricity Rules* and associated legislative framework. It follows from this, and from the Ministerial Council on Energy's key policy goals for energy market reforms which led to the recently revised framework, that the network sector does not consider that a review of current regulatory arrangements in the areas outlined by IPART is warranted. This view is reinforced by the fact that promotion of a stable regulatory environment, which supports the capacity of network businesses to both efficiently finance and make significant sunk capital investments on an ongoing basis, is clearly in the interests of current and future energy consumers.

Recommended approach

Based on its assessment of the Draft Report, ENA recommends that the Tribunal should:

1. engage in an open and constructive dialogue with participants in the network sector to gather more direct evidence on issues around the contents and interpretation of the NER; and
2. review its analysis of the impact of the *National Electricity Rules* on network prices and the associated recommendation calling for a review of these arrangements.

2. Background

ENA is the peak national body for Australia's energy networks which provide the vital link between gas and electricity producers and consumers. ENA represents gas distribution and electricity network businesses on economic, technical and safety regulation and national energy policy issues.

Energy network businesses deliver electricity and gas to over 13.5 million customers, employ more than 40 000 people and contribute approximately 1.25 percent to Australia's gross domestic product. Energy is delivered across Australia through approximately 48 000 km of transmission lines, 800 000 kilometres of electricity distribution lines and 81 000 kilometres of gas distribution pipelines. Energy network businesses are valued at over $65 billion and annually undertake an average investment of approximately $12 billion in network operations, reinforcement, expansions and greenfield extensions.

3. National economic regulatory rules

The Draft Report released by IPART makes a number of observations about the design and operation of national economic regulatory rules applying electricity and gas networks. Each of these observations is addressed in turn in the following sections.

3.1 The 'burden of proof' on the regulator under the NER

The Draft Report posits that the AER is faced with an '*unusually high*' burden of proof in rejecting or amending regulated businesses' spending proposals. Energy network businesses do not consider that this is an accurate characterisation of either the terms of the NER, or empirical evidence from the operation of the Rules by the AER.[1]

The AER has recently approved, after lengthy, public, and detailed deliberations in accordance with the Rules, substantial increases in capital and operating expenditure in some jurisdictions. This does not, however, provide evidence that the AER lacks sufficient discretion under the NER to reject or amend expenditure proposals. Rather, it is evidence that an independent national energy regulator operating under a recently modernised regulatory framework has satisfied itself that significant increases in network investments are required to promote the long-term interest of consumers in the safe and reliable delivery of regulated electricity services.

A balanced assessment of the design and operation of the 'regulatory package' put in place by the Australian Energy Market Commission (AEMC) and the Ministerial Council on Energy (MCE) in relation to the regulation of networks, as well as the terms of the rules themselves, do not support IPART's view that the burden of proof is set inappropriately high.

3.1.1 Policy design underlying the 'fit-for-purpose' regulatory model

Both the MCE and the AEMC carefully considered the issue of the appropriate level of discretion in considering proposed expenditure in the design phases of current energy regimes, including the trade-offs and risks of both highly prescriptive and highly discretionary approaches. Their judgements on these issues were further informed by a series of comprehensive and influential expert reviews on appropriate approaches to access pricing, including the Productivity Commission *Review of the National Access Regime* and *Review of the Gas Access Regime*, the Prime Minister's Export Infrastructure Taskforce review, and the report of the MCE's Expert Panel on Energy Access Pricing.

The electricity network regulatory rules thus reflect a carefully designed 'fit-for-purpose' model under which the Ministerial Council on Energy and AEMC provided appropriate and tailored levels of discretion to accept or reject individual elements of regulatory proposals, guided by specific criteria, principles and the energy law objectives. Both the AEMC in its development of a revised Chapter 6A for the *National Electricity Rules* relating to transmission services and the MCE in its adoption of revisions to Chapter 6 of the *National Electricity Rules* covering distribution networks emphasised that these rules were intended to provide the AER with clear and unambiguous scope to reject 'inflated' or unrealistic expenditure proposals.[2] This is outlined clearly by the AEMC in its final determination in respect of the Chapter 6A electricity transmission revenue rules:

> The Commission believes that the subject of the regulation – the forecast capital expenditure and operating expenditure for substantial, highly complex and technical infrastructure for a five-year period is not a matter that is amenable to the level of precision and confidence that would enable one to sensibly say there is one correct or "best" figure. It considers that Rules that could be interpreted in that way are likely to result in a heightened risk of regulatory error. Equally the Commission does not intend that the Rules contemplate such a range of permissible outcomes that there is a risk of inherent bias toward higher amounts. Having regard to these considerations the Commission has elected to adopt a decision rule which requires the AER to accept the TNSP's proposal if it is satisfied that the amount "reasonably reflects" efficient and prudent costs based on realistic estimates of forecast demand and cost inputs.[3]

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[1] It is also noted that the concept of 'burden of proof' is not strictly applicable to administrative decision-making. The discussion below assumes that IPART uses the term more loosely in reference to the scope of the AER's discretion to reject elements of a regulatory proposal.

[2] Australian Energy Market Commission *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18*, November 2006, p.33 and Table 1 - *SCO Response to stakeholders comments on the exposure draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, p.25-28

[3] AEMC (2006), p.52

This makes clear the policy intent of the AEMC to avoid regulatory allowances including inflated or inefficient levels of expenditure, as well as illustrating some of the policy considerations that led both the MCE and AEMC to prefer a 'fit-for-purpose' regulatory model with tailored levels of regulatory discretion.

3.1.2 Errors and omissions in analysis of NER obligations

The IPART Draft Report does not accurately reflect the actual nature of the NER criteria for decisions on operating and capital expenditure forecasts. Under this framework, the AER is not obliged to 'prove' any affirmative case, as suggested by IPART. Rather, the AER is required to form a view as to whether it is satisfied that a networks' forecasts in its regulatory proposal meet the operating or capital expenditure criteria contained in the Rules. If the AER is not satisfied, it is required to derive a forecast expenditure which is consistent with the NER and substitute it for that put forward by the network business.

Key elements of the NER which critically affect the scope of AER discretion are incompletely reflected in, or omitted completely from, the IPART analysis. For example:

- the AER is explicitly forbidden from accepting operating and capital expenditure forecasts where it is not satisfied the spending meets the operating expenditure criteria (See NER Cl.6.5.6 (d));
- the AER is provided with a wide range of factors (10 each in relation to capital and operating costs) to have regard to in reaching a determination on cost forecasts (See NER Cl.6.5.6 (e) (1)-(10));
- these factors include scope for the AER to have regard to its own internal analysis, assessments of benchmark efficient costs, and past actual expenditure, providing a number of bases under which in applying the rules the AER may reject or amend forecast expenditures; and
- the issue of whether the NER expenditure provisions created a 'burden of proof' was subject of detailed consideration and advice from Senior Counsel to the AEMC in the drafting of the relevant rules – this advice confirms no such 'burden' arises for the AER.[4] Further, the review body, the Australian Competition Tribunal has subsequently provided guidance that again makes clear that the AER's duties under the NER are established by direct reference to rules provisions, rather than in the context of any overarching 'burdens of proof'.[5]

The claim by IPART that the AER lacks sufficient regulatory discretion to conduct its task under the regulatory framework is also inconsistent with the empirical evidence since the commencement of the operation of revised electricity framework.

In none of 10 major electricity network pricing determinations to date has the AER expressed concern that the operation of the NER limits its capacity to deliver decisions that promote the *National Electricity Law* objective. In contrast, the AER has routinely amended proposed capital and operating cost forecasts according to its interpretation of the spending that is consistent with the NER. In fact, the only (rare) instances of Australian regulators accepting without amendment proposed cost forecasts have occurred outside of the NER framework.

Were the proposition true that a 'burden of proof' has been made inappropriately high by the introduction of revised NER in 2006, then two significant trends could be expected to be observed:

- First, larger average reductions between proposed expenditures and allowed expenditures under previous State-based regulatory approaches compared to regulation by the AER under the revised NER; and
- Second, potentially systematic differences in the average level of operating and capital cost reductions in gas compared to electricity regulatory decisions, given that the Natinoal Gas Rules (NGR) provide the AER with discretion to reject or amend spending not based on the 'best forecast' or estimate possible in the circumstances (Rule 74, see also Rule 79 and 91)

From an examination of decisions currently in force, however, what is actually seen is very mixed evidence with no clear support for either of these expected trends. In contrast, what can be observed is:

[4] AEMC (2006), p.52

[5] *Application by Ergon Energy Corporation Limited [2010]* ACompT 6, [51]

- Larger percentage reductions in proposed capital expenditure programs by previous State-based jurisdictional regulators, but percentage reductions by the AER in operating expenditures which are nearly **double** the size of those from jurisdictional regulators (7.1 per cent compared to 3.7 per cent)

- Larger reductions in capital expenditure allowances in gas than in electricity (10.5 per cent compared to 9.9 per cent) , but **smaller** average reductions in relation to operating costs (4.2 per cent compared to 4.9 per cent)

Whilst the sample of network regulatory decisions in force is relatively small (at 20 decisions), neither of these observed findings provide supporting evidence for IPART's contentions. Empirical evidence does not support the claim that the regime has allowed inflated or inefficient expenditure to be accepted.

3.2 Operation of network appeal processes

The appeal process under the *National Electricity Law* is a form of limited merits review which like other administrative and judicial appeal mechanisms focuses on the issues in dispute between the two parties. This is the result of a deliberate policy decision taken by the Ministerial Council on Energy to establish a form of review that was timely, efficient, and focused on improving the quality of primary regulatory decision-making and correcting regulatory errors.[6]

Providing the appeal body a wider remit in the manner suggested by IPART to review the decision at large and remake elements of the decision outside of the areas in practical dispute would alter the model to a form of full *de novo* review. This development is at odds with the recent policy design decisions of both the Ministerial Council on Energy in respect of electricity and gas regimes, and the Council of Australian Government in respect of the generic national access regime operating under Part IIIA of the *Competition and Consumer Act*.

Merits review mechanisms continue to be considered elements of modern best practice access frameworks, a point most recently reinforced by the independent Productivity Commission's ongoing review of the urban water sector.[7] The Productivity Commission notes in particular the effect of diminished accountability of regulators and increased scope for regulatory errors where review mechanisms are constrained. It also notes the role merits review plays in safeguarding the rights of those regulated, and encouraging the identification and correction of ineffective regulation.

It is incorrect that the Australian Competition Tribunal is prohibited from examining the broader consequential effects of the issues in dispute in energy appeals. In fact, the AER has wide powers to raise, as a review related matter, outcomes or effects which consequentially arise from the matters in dispute.[8] The appeals provisions in the national energy laws provide that the Tribunal does not reconsider the entire AER decision because as a matter of sound regulatory policy each constituent element of the AER's decision is required to be reasonable and free of material errors. A significant benefit of this approach is that there is transparency as to each element of a decision, promotion of predictability and replicability of decisions, avoiding unaccountable 'black box' decision-making. As IPART appears to be basing its analysis on incorrect assumptions about the actual terms and operation of the appeal framework, it follows that its conclusion that a bias is thereby created in favour of higher or inefficient prices cannot be sustained. Rather, a limited appeal mechanism creates incentives for reasonable and soundly based regulatory decision-making, free from regulatory errors, and the efficient resolution of merits-based reviews.

IPART suggests that the current appeals arrangements lead to network businesses not being required to consider whether they could end up 'worse off' as a result of initiating a review. This proposition is incorrect. The decision to commence an appeal under the current framework needs to take account of substantial potential risks and costs. Contrary to IPART's assertion, a network business does face the real prospect of adverse outcomes from initiating a review through the capacity of a range of parties and interveners to raise additional review matters which have the potential to lead to material downward revisions to allowable revenues.[9] This creates the potential for other wider elements of the decision to be opened for review, to the potential material disadvantage of the network business. In addition, Ministers of participating jurisdictions may intervene without leave.

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[6] MCE *Decision on Review of Decision-Making in the Gas and Electricity Regulatory Frameworks*, May 2006, p.3

[7] Productivity Commission – *Australia's Urban Water Sector – Draft Report*, 13 April 2011, p.92 and p.290

[8] National Electricity Law, s.71O (1)(b)

[9] National Electricity Law, s.71M- O

These combined circumstances create an environment in which a decision by a business to appeal must be carefully balanced against the potential for other additional review issues to be pursued by AER, the Minister, consumer representative bodies, and end users. Additionally, IPART's analysis does not account for the substantial direct and indirect financial costs of a review application and process. The analysis also ignores broader impacts of the review process that network businesses must consider, including diversion of senior commercial management resources, and, potentially, adverse impacts on the ongoing working relationship with the regulatory body concerned.

The alternative raised by IPART of providing for judicial review of decisions only does not meet the objectives set by the Ministerial Council on Energy for a sound and effective review mechanism.[10] The option of providing judicial review only to decisions was rejected in the MCE's policy decision on review arrangements because it would not permit the correction of as full a range of likely regulatory errors with adverse societal consequences as a system which featured merits-based review. In making this decision, the MCE recognised that rather than being substitutes, merits and judicial review are in fact discrete but complementary mechanisms.

3.3 Determining regulatory returns under the NER

The *National Electricity Rules* provide guidance to the AER in determining regulatory returns which is significantly more detailed than applies under legislative frameworks under which IPART operates. This approach, however, is the deliberate result of a significant modernisation and updating of the design of regulatory frameworks applying to networks by MCE and AEMC from 2005-07.

A core objective of this process of policy reform was establishing a regulatory framework which promoted the national electricity and gas objectives, and provided increased levels of investment certainty by improving the quality and predictability of economic regulatory decision-making.[11] As part of this reform process, the AER effectively assumed responsibility for network revenue regulation from jurisdictional regulators such as IPART from 2008 onwards. This has arguably led to a significant divergence between the frameworks typically applied by jurisdictional regulators and the recently adopted frameworks in energy. This fact, however, does not establish that these modernised national regulatory frameworks which are distinct from those applied by bodies such as IPART are inferior or, as claimed, unduly prescriptive. Rather, the deemed consistency of national energy access regimes with a set of best-practice principles set out in revised national competition agreements such as the 2006 *Competition and Infrastructure Reform Agreement* suggests that the energy access regimes display features which are more consistent with the best practice regulation of significant infrastructure than a range of State-based frameworks IPART currently applies.[12]

The level of guidance in Chapter 6 and 6A of the *National Electricity Rules* reflect a policy decision on the part of MCE, the AEMC and a wide range of industry and others stakeholders to 'codify' some elements of widely accepted regulatory practice to enhance the predictability and replicability of regulatory decision-making, to enhance investment certainty. The claim that this codification has resulted in an overly prescriptive approach which leads to excessive returns, however, cannot be sustained on the basis of the *National Electricity Rules*, or their application and interpretation by the AER for several reasons.

First, the NER does provide for appropriate scope for the AER to appropriately adjust the WACC for changing market circumstances at the time of the network pricing decision. Under the NER, the cost of capital is set on a forwarding looking basis with market varying parameters set to reflect the return required by investors in commercial enterprise with a similar nature and sets of risks as a network business. In both the transmission and distribution rules, the debt risk premium, and risk free rate underpinning the WACC are required to be adjusted to reflect market conditions. In the case of distribution, both the network business and the AER are also permitted to seek adjustments to other WACC parameters (such as equity beta or market risk premium) which are typically varied less frequently in response to persuasive evidence that justifies the adoption of different values. In either case, network businesses bear the downside risks where the actual cost of financing exceeds the benchmark WACC assumption.

Over the period 2009 to 2011, the AER has applied a number of changes to equity beta assumptions of networks businesses in distribution network determinations, as well as varying the market risk premium to take into account

[10] MCE (May 2006) p.13-15

[11] See for example *Australian Energy Market Agreement*, Clause 2.1

[12] See Council of Australian Governments *Competition and Infrastructure Reform Agreement 2006*, Clause 1.13

an increase in the risk premium due to the GFC, and more recently, a claimed easing of adverse capital market conditions. It is noted that over this same two year period, IPART itself has not varied its key market risk premium assumption, despite generally operating under frameworks featuring lower levels of direct prescriptive regulatory guidance on cost of capital issues. Similarly, IPART has an overall record of stability in relation to its equity beta assumptions for regulated utility businesses that does not differ significantly from the AER (which in fact, adopted a sharper reduction in its beta assumption in its 2009 generic cost of capital review than has been typical of the majority of IPART's decisions). In the case of electricity transmission, values for parameters such as the market risk premium and equity beta are applied mandatorily between five yearly cost of capital reviews. As noted above, this achieves the policy goal of enhancing regulatory and investment certainty, and provides a similar degree of consistency as IPART itself has chosen to adopt in relation to these same parameters.

Second, the AER has made clear in a series of electricity network decisions, and the generic cost of capital review itself, that the application of the current NER does not provide for, or intend, a 'mechanistic' setting of a WACC value. The AER has instead emphasised the role of judgement and discretion under the broad guidance provided by the national electricity objective and revenue and pricing principles.

Third, the codification of some cost of capital parameters merely builds on previous initiatives voluntarily undertaken by the ACCC itself to provide greater guidance and certainty over its approach to network revenue regulation. This is evident from the self-initiated preparation by the ACCC of the *Statement of Regulatory Principles for the Regulation of Transmission Revenue* (SRP) which was developed, revised and issued by the ACCC over the period from 1999-2004. In significant areas, the NER builds on and adopts the outcomes of the SRP, with the principal difference under the new market and institutional governance arrangements being that the NER's codification is now open to challenge, and potential rule changes from a wider range of market stakeholders than the ACCC's previous statement.

3.4 Approaches to adjusting the asset base for capital expenditure

The NER adopts an *ex ante* approach to the addition of capital expenditure to the regulatory asset base, meaning actual capital expenditure undertaken to assist in the delivery of regulated services is recovered from current and future consumers.

IPART appears to be suggesting a reversion to a previous regulatory approach know as 'ex post' assessment, under which a regulator is provided wide discretion to review past expenditure and disallow recovery of actual network investments made on a retrospective basis. This approach is at odds with the policy choices adopted by ACCC, the Ministerial Council on Energy and the AEMC in their application and design of third party access regimes over the past decade. *Ex post* approaches to capital expenditure are subject to wide criticism in regulatory policy terms due to the:

- capacity for increased regulatory risk and uncertainty for service provider to more than offset any potential efficiency benefits;
- intrusive nature of applying the framework, requiring a regulatory body to effectively 'second guess' on the basis of information not before the network business at the time of the investment, the prudency of the investment; and
- potential consequences of the 'chilling impact' of such reviews on undertaking efficient investment underpinning the safe, reliable and efficient delivery of network services.

The ENA would encourage IPART and any subsequent review body to closely examine the full range of regulatory policy considerations which have to date led the ACCC, MCE and AEMC to reject the *ex post* approach to capital investment assessment. A balanced review of this matter should likewise consider the range of commonly identified deficiencies in *ex post* approaches which led to a broad consensus in favour of the adoption of superior *ex ante* approaches in revised electricity access frameworks.

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