



Australian Energy Market Commission

CONSULTATION PAPER

Consolidated Rule Request - National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011

Rule Proponents

Australian Energy Regulator and
Energy Users Rule Change Committee – Amcor, Australian Paper, Rio Tinto, Simplot,
Wesfarmers, Westfield and Woolworths

3 November 2011

RULE
CHANGE

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. The AEMC has two principal functions. We make and amend the national electricity and gas rules, and we conduct independent reviews of the energy markets for the MCE.

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1 Introduction

On 18 October 2011, the Australian Energy Market Commission (AEMC or Commission) received a rule change request from an Energy Users Rule Change Committee representing Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths (the Energy Users Committee) (the Proponents) relating to the calculation of return on debt for electricity network businesses under Chapters 6 and 6A of the National Electricity Rules (NER).¹

The Energy Users Committee's rule change seeks to address what it considers to be one of the main failures of the NER that is contributing to rising network charges resulting from higher capital expenditure and higher regulated rates of returns – ie the methodology for the calculation of the return on debt component of the rate of return allowance.

This Consultation Paper has been prepared by the staff of the AEMC to facilitate public consultation on the rule change proposal and does not represent the views of the AEMC or any individual Commissioner of the AEMC. As the AEMC is consolidating the Energy Users Committee's rule change request with the previously initiated Economic Regulation of Network Service Providers rule change request from the Australian Energy Regulator (AER), this Consultation Paper should be read in conjunction with the Consultation Paper issued for the AER's rule change request on 20 October 2011.

This paper:

- sets out a summary of the rule change request submitted to the AEMC by the Energy Users Committee;
- describes the consolidated process the AEMC is following in dealing with this rule change request and the AER's rule change request;
- invites comments on the consolidated rule request and identifies a number of issues in relation to the Energy Users Committee's rule change proposal on which the AEMC would welcome views; and
- outlines the process for making submissions on the consolidated rule request.

¹ Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt*, dated 17 October 2011.

2 Details of the Rule Change Request

The Energy Users Committee has submitted a rule change request to change the methodology specified in the NER for the calculation of the return on debt component of the Weighted Average Cost of Capital (WACC) that is used to determine the return on assets allowance for regulated electricity network service providers (NSPs).

As the Energy Users' Committee's rule change request sets out the issues and the proposed solution in detail, we have only summarised it at a high level below. The rule change request is available on the AEMC's website.

2.1 Issues identified in the rule change request

The Energy Users Committee believes that the existing methodology for calculating the return on debt and its implementation by the AER is flawed. The rule change request states that this flaw is a result of two errors when the return on debt has been determined by the AER to date:

- errors of commission (the wrong benchmark has been specified); and
- errors of omission (insufficient weight is placed on actual debt costs).

The Energy Users' Committee's rule change request states that the benchmark debt term and credit rating determined by the AER in accordance with the current rules (10 year BBB+ rated debt issued by Australian corporates) are inappropriate benchmarks as there are no corporate bonds issued in Australia that meet this requirement of tenure and credit risk at the time that the AER has made its price/revenue decisions for NSPs. The rule change request states that, as a result, the AER has had no option other than to develop estimates based on short-term bonds and bonds with different credit ratings.

The Energy Users Committee believes that the benchmark tool used by the AER – the Bloomberg Fair Value curve, but using just a small handful of relevant bonds is not appropriate either. The rule change request states that jurisdictional regulators such as the Independent Pricing and Regulatory Tribunal in New South Wales and the Economic Regulation Authority of Western Australia have rejected this benchmarking tool and NSPs have also questioned its use.

A further benchmark related issue identified by the Energy Users Committee is the requirement to establish both the risk free rate and the debt risk premium based on information obtained during a short period (15 to 20 working days) near to the start of the regulatory period. The rule change request notes that the constituent parameters of the return on debt (the risk free rate and the debt risk premium) have varied significantly over short periods and the time period currently specified in the rules are inappropriate to estimate these parameters.

With respect to its claim on errors of omission, the rule change request states that since the current rules require that the return on debt reflect “the current cost of borrowings for comparable debt”, this suggests that the AER should have regard to the *actual debt costs* of the NSPs in setting the return on debt. However, the specific requirements of Clause 6.5.2 (b) that “[T]he rate of return for a Distribution Network Service Provider for a regulatory control period is the cost of capital as measured by the return required

by investors in a commercial enterprise with a similar nature and degree of nondiversifiable risk” could be seen to provide specific instruction of how the “current cost of borrowings for comparable debt” is to be established. With this reading of the rules, the Energy Users Committee believes that the AER is arguably effectively precluded from having regard to the actual cost of debt.

As a result of these flaws, the Energy Users Committee claims that higher than the actual cost of debt allowance has been given to NSPs, which has resulted in excessive profits to NSPs’ shareholders, higher prices for electricity users and perverse incentives for inefficient over-investment.

The Energy Users Committee believes that the National Electricity Objective (NEO) requires that the return on debt, whether for government or privately owned NSPs, should reflect the actual cost of debt. It further believes that regulated NSPs should, in principle, not profit on the debt they raise.

The rule change request states that there is compelling evidence that privately owned electricity NSPs – who constitute approximately 25% of the industry (by assets) have a cost of debt that is around 250 basis points lower than the return on debt that the AER has determined in the NSPs revenue allowances. For the remaining 75% of the industry that are government-owned NSPs, whose debt is provided by jurisdictional governments, the Energy Users Committee claims that this gap rises to around 350 basis points.

2.2 Proposed solution

The Energy Users Committee is proposing to amend the WACC methodology under Chapter 6 and 6A of the NER to require the AER to determine the return on debt in a way that they consider more closely reflects the actual cost of debt. Its proposal will effectively require the return on debt for government-owned NSPs to be determined on a different basis to privately owned NSPs, as follows:

- **For privately owned NSPs** - the return on debt for each year of a regulatory control period would be established through a five year rolling average of the Fair Market Value yield of five year investment grade (broad BBB and broad A rated) corporate debt issued in Australia.
- **For government-owned NSPs** - the return on debt for each year during a regulatory control period would be based on the average yield to maturity (for the previous calendar year) of all bonds issued by the respective state governments, which have between three and seven years to maturity.

The Energy Users Committee believes that for privately owned NSPs, the use of an index that reflects fair value estimates of the yield to maturity on investment grade corporate debt issued in Australia will provide appropriate incentives for them to minimise their debt costs.

For government-owned NSPs, the Energy Users Committee considers that it would be inconsistent to allow them to charge users for a cost of debt as if they were privately owned. It states that such an approach – which currently applies – contravenes the Competition Principles Agreement and is also unsupported by economic theory.

The rule change request makes references to return on debt provisions of Chapter 6 of NER only and includes draft rules for that Chapter, although the proposal extends to Chapter 6A. The Energy Users Committee states that the same analysis and conclusions apply to the relevant clauses of Chapter 6A and has requested that the same drafting changes be considered for Chapter 6A of the NER.

2.3 The AER rule change request

On 29 September 2011, the AER submitted two rule change requests to the AEMC. One rule change request relates to economic regulation of electricity transmission and distribution businesses (the Economic Regulation of Network Service Providers rule change request) under the National Electricity Law (NEL), and the other relates to determining the rate of return provisions for gas transmission and distribution businesses (the Price and Revenue Regulation of Gas Services rule change request) under the National Gas Law.

As part of the Economic Regulation of Network Service Providers rule change request (the AER rule change request), the AER has also identified the WACC frameworks under Chapter 6 and 6A (as well as the equivalent provisions for gas network businesses under the National Gas Rules) as an area that it considers needs changes.

The AER's rule change request considers the different arrangements for determining the WACC in electricity distribution and transmission, and proposes an approach which most closely aligns with the current electricity transmission arrangements, but with some additional changes.

The AER is proposing to amend the current rules to require it to conduct a periodic WACC review at intervals of no more than five years. The outcomes of the review would apply to each subsequent electricity and gas transmission and distribution network revenue determinations during that five year period (as per the current arrangements for electricity transmission network businesses), with no ability for the AER to depart from the parameters established in the WACC the review in a subsequent regulatory determination.

Specifically, the AER rule change request on the NER proposes to:

- increase the scope of the WACC reviews to include the methodology for setting the return on debt parameters (specifically determining the debt risk premium) in addition to the existing requirement to review the return on equity parameters of the WACC;
- in respect of WACC reviews, require the AER to have regard to previously adopted values, rather than being potentially bound by previously adopted values. No persuasive evidence test would apply at the time of each periodic WACC review; and
- align the provisions relating to the timing of WACC reviews across chapter 6 and 6A (and gas network businesses under the National Gas Rules), which would allow the AER to initiate reviews before the expiry of a five year interval (as per the current arrangements for electricity distribution network businesses).

The rule change process for the AER's rule change requests were initiated by the AEMC on 20 October 2011.²

2.4 The Proponents views on the AER rule change request

The Energy Users Committee in its rule change request acknowledges that the AER's rule change request identifies and seeks to address the return on debt issue that has been identified by it in its own rule change proposal. However, the Energy Users Committee states that it does not agree with the AER's proposed solution of dealing with the issue through periodic WACC reviews outside of the NER.

The AER's proposed changes are not consistent with the Energy Users Committee's proposal in the following ways:

- the AER proposes to establish the methodology for the debt risk premium used in the calculation for the return on debt during its periodic WACC reviews whereas the Energy Users Committee proposes that the methodology for the calculation of the return on debt (and the relevant constituent parameters such as the debt term and credit ratings for determining the debt risk premium) should be specified in the NER, rather than subject to the determination by the AER during its proposed WACC reviews; and
- the AER's proposal to periodically review the debt term and credit rating of the benchmark bonds is inconsistent with the Energy Users Committee's proposal that these parameters be fixed in the NER rather than set by the AER through its proposed WACC reviews.

The Energy Users Committee states that the return on debt outcomes that have been delivered so far do not reflect a lack of regulatory discretion in the WACC framework of the NER [as claimed by the AER in its rule change request]. Accordingly, to be assured of appropriate outcomes in this area, the Energy Users Committee considers that the methodology for determining the return on debt (and relevant parameters such as debt term and credit ratings for calculation of the debt risk premium) should be specified in the NER. It believes that this is an urgent issue and clear resolution rather than deferral to indeterminate future regulatory WACC reviews by the AER is preferable.

The Energy Users Committee further states that in comparison to the AER's proposed approach, its proposed approach will reduce the scope of on-going, repeated consultation by setting the determination of the return on debt in the rules. It states that its approach will reduce the need for repeated consultation and hence help to reduce advocacy burdens on consumers and also diminish opportunities for lobbying from well-resourced NSPs who can recover the costs of their lobbying through regulated charges.

In addition, the Energy Users Committee states that its proposal challenges an entrenched policy that discriminates in favour of government-owned NSPs, and a review adjudicated against the delivery of the NEO, should decide this challenge rather than a review by the AER.

² The AER's rule change requests, including its proposed rules are available on the AEMC's website.

As the WACC issue addressed by the AER rule change request overlap with the return on debt issue raised in the Energy Users' Committee's rule change request, the AEMC has had to consider how best to deal with the two rule change requests in a timely and efficient manner within the statutory rule change process under the NEL. The AEMC's rule change process for the Energy Users' Committee's rule change request is discussed in the following chapter.

3 Rule Change Process

The AEMC has determined that the Energy Users' Committee's rule change request meets the statutory criteria set out in section 94 of the NEL including that the Commission has the power to make the proposed rules, and therefore is initiating the rule change process for the proposed rules.

As noted in the previous chapter, the AEMC has also initiated the rule change process on the AER's rule change request on the Economic Regulation of Network Service Providers (AEMC project reference ERC0134) that effectively deals with the same subject matter as the Energy Users' Committee's rule change request on the return on debt component of the WACC.

Having regard to the fact that two rule change requests have raised issues in the WACC rules on the same subject matter, the AEMC has decided the two rule change requests should be dealt with together for the purposes of making of a rule by the AEMC under Part 7 of NEL.

Under section 93 of the NEL, the AEMC is able consider whether to consolidate two or more rule change requests, which is as follows:

93 – Consolidation of 2 or more Rule requests

- (1) If the AEMC considers it necessary or desirable that 2 or more requests for the making of a Rule should be dealt with together, the AEMC may –
 - (a) treat those requests as 1 request for the purposes of this Part (a *consolidated Rule request*); or
 - (b) treat any later request as a submission in relation to the earliest Rule request.
- (2) For the purposes of this Part, the AEMC may treat a consolidated Rule as being received by it on the day it receives either the first or last of the Rule requests forming part of the consolidated Rule request.

In accordance with section 93(1)(a), the AEMC considers that there are sufficient grounds to treat the Energy Users' Committee's rule change request and the AER's rule change request as a consolidated rule request to the extent the subject matter relates to the issues raised on the WACC framework. The AEMC has not exercised its discretion to treat the Energy Users' Committee's rule change request as submission under section 9' (1)(b) given that both the Energy Users Committee's and the AER have raised issues in the WACC rules on very different grounds and have consequently proposed two very different rule proposals to address those issues.

Through consolidation, the AEMC will be able to consider the issues raised by both rule change requests together and make an informed decision about the problems identified in the WACC framework for NSPs in the rule change requests. Additionally, consolidation will make it easier for stakeholders to engage in the rule change processes. By consolidating, stakeholders will not be required to provide submissions twice on what may be, to the stakeholder, essentially one matter on very similar issues.

As a result of this consolidation, the AEMC is effectively initiating a new rule change request process. However, to minimise confusion for stakeholders, the AEMC will follow the timetable that was established for the AER rule change request. Accordingly,

submissions on first round consultation on the consolidated rule request will close on 8 December 2011. This date is the same as that was originally provided for the AER rule change request. The consultation timeframe still allows stakeholders approximately five weeks to make submissions on the consolidated rule request, which is one more week than the minimum time required under the NEL.

Due to the complex nature of the issues in the consolidated rule request, the AEMC has determined under section 107 of the NEL to extend the length of the consolidated rule change process. The AEMC has extended the time for making of the Draft Rule Determination to 26 July 2012, as was the case for the AER's Economic Regulation of Network Service Providers rule change request prior to consolidation.

The process for the now consolidated Economic Regulation of Network Service Providers rule change request (incorporating the Energy Users' Committee's rule change proposal) will be as follows:

- The AEMC will hold a public forum in Brisbane on 23 November 2011. At the forum, the AER and the Energy Users Committee will outline their rule change proposals, the AEMC will describe its process, and representatives of stakeholder groups will be given the opportunity to present their views on the consolidated rule requests.
- Following close of submissions on first round of consultation on the rule change requests on 8 December 2011, the AEMC will publish a Directions Paper in late February 2012. The Directions Paper will set out the AEMC's preliminary views on the rule change requests;
- Stakeholders will have the opportunity to make submissions on the Directions Paper in a second round of consultation;
- The Commission will then prepare and publish a Draft Determination by 26 July 2012, along with any draft Rule;
- In the third round of consultation stakeholders may make submissions on this Draft Determination and any draft Rule;
- Following consideration of these submissions the Commission will prepare and publish a Final Determination and final Rule by 15 October 2012.

This rule change process is set out in more detail, with indicative dates, in the timetable in Appendix A.

On 31 October 2011, the Special Commission of Inquiry into Electricity Transactions in New South Wales published its final report. This report included some comments about the AER's rule change proposals. For the avoidance of doubt, the AEMC re-iterates that it has not reached any views on the merits or otherwise of the AER's proposed rule changes, or the Energy Users Committee's proposed rule changes for that matter. The AEMC will undertake the consultation process set out above before reaching any conclusions about the rule change requests.

4 Issues for Consultation

The Energy Users' Committee's rule change request sets out its proposal and provides a supporting report from a consultant. The rule change request also includes a draft rule for proposed amendments to Chapter 6 of the NER which relates to distribution network businesses. As the rule change request states that the same analysis and conclusions apply to the relevant clauses of Chapter 6A and that the same drafting changes be considered for Chapter 6A of the NER, a draft of proposed amendments to Chapter 6A of NER has been prepared based upon the information contained in the rule change request to assist stakeholders in considering the proponent's proposal at this stage of the process.³ The Chapter 6A proposed amendments has been published along with the rule change request.

We encourage stakeholders to consider the Energy Users' Committee's rule change request together with the AER rule change request on the WACC framework changes that have been proposed. Stakeholders are encouraged to raise any specific comment as early as possible in the rule change process, to enable the AEMC to give it the fullest possible consideration.

As a general guide, it would greatly assist the AEMC in its assessment if stakeholders commented on whether or not they agreed with the problems identified by the proponents, and if so, to what extent do the solutions proposed address the problems identified.

We also encourage stakeholders to consider commenting on the likely costs and benefits of making the rule changes proposed by the proponents and their justification for why the rule change will better meet the NEO. Furthermore, we ask stakeholders to, wherever possible, provide quantitative analysis or data which support any proposition or position in their submission. To the extent a submission refers to separate materials (such as reports or studies), these should be included in the submissions or appropriate public access reference provided.

In addition to the comments sought above, we have identified a number of issues for consultation that appear to be relevant to the Energy Users Committee's rule change proposal.

The issues outlined below are provided for guidance. Stakeholders are encouraged to comment on these issues as well as any other aspect of the rule change proposal they consider relevant:

- **Excessive profits to NSPs** – In its rule change request, the Energy Users Committee has attempted to quantify what it considers “excessive profits” being made by NSPs as a result of higher return on debt allowances than their actual cost of debt (section 2.3.1 and Appendix 1 of the rule change request). It also suggests that State Governments receive these profits as well as the tax on those profits from the NSPs that they own. Stakeholders are encouraged to comment on

³ The rule proponent has acknowledged that there are some minor drafting errors in the proposed rules on Chapter 6 of the NER included in its rule change proposal. However, the rule proponent does not consider those errors to be material to the substance of the rule changes sought. The proposed amendments to Chapter 6A of the NER seeks to correct those identified errors.

the excessive profit analysis presented in the rule change request including the data on actual cost of debt estimates and indicate whether they agree or disagree with the propositions put by the Energy Users Committee.

- **Government-owned NSPs vs privately owned NSPs** – One of the key issues identified in the Energy Users Committee rule change request is that the debt raising costs of government-owned NSPs is different to NSPs in private ownership. It also asserts that government-owned NSPs are able to leverage the higher credit ratings of their respective government owners and raise debt at much lower costs, while their actual debt costs are independent of the allowance set by the AER. Hence the government-owned NSPs cannot respond to any efficiency incentives to minimise their cost of debt. We would like to get stakeholders views on whether this difference should be taken into account in determining the return on debt element of an NSP's WACC. We are particularly interested in comments from the relevant NSPs and State Governments on how debt is raised on behalf of the government-owned NSPs and how the debt costs are levied on to the NSPs, including information on the extent to which any government guarantee fees/competitive neutrality fees apply to NSPs. We would also welcome views on whether the measures of debt costs identified by the Energy Users Committee are the appropriate benchmarks for government-owned and privately owned NSPs.
- **Competitive neutrality and capital market discipline issues** – In section 3 of the rule change request, the Energy Users Committee has outlined its arguments for why it believes it is justifiable for government-owned NSPs to be treated differently to privately owned NSPs in determining the return on debt. Stakeholders are encouraged to comment on implications for competitive neutrality in the context of the Competition Principles Agreement arising from treating government-owned NSPs differently to privately owned NSPs. What other issues should be considered?

5 Lodging Submissions

Submissions are to be lodged online or by mail by 8 December 2011 in accordance with the requirements set out below. The AEMC is expecting a significant number of submissions so in order to be given full consideration submissions must be received by the close of the consultation period. **Submissions that are received after this time may not be given full weight.** Where practicable, submissions should be prepared in accordance with the Commission's Guidelines for making written submissions on rule change requests. The Commission publishes all submissions on its website subject to a claim of confidentiality.

All enquiries on this project should be addressed to Zaeen Khan on (02) 8296 7800.

5.1 Lodging a submission electronically

Electronic submissions must be lodged online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code ["ERC0134"]. The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

5.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by Fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0134.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter.

If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

Abbreviations

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Commission	See AEMC
Energy Users Committee	Energy Users' Rule Change Committee representing Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths
NEL	National Electricity Law
NER	National Electricity Rules
NEO	National Electricity Objective
NSP	Network Service Providers
WACC	Weighted Average Cost of Capital

Appendix A Indicative Timetable for the Consolidated Rule Request

Milestone	Date
AER's Rule change request received	29 September 2011
AEMC issues notices to commence rule making process for AER's Economic Regulation of Network Service Providers rule change request and invites first round submissions from stakeholders under section 95 of the NEL	20 October 2011
AEMC issues notices to extend the time period for making the Draft Rule Determination on AER's rule change requests under section 107 of the NEL	20 October 2011
Energy Users' Committee's (representing Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths) rule change request received	18 October 2011
AEMC issues notice under section 95 of the NEL to commence a consolidated rule making process in accordance with section 93 of the NEL for Energy User's Committee's rule change request and the AER's Economic Regulation of Network Service Providers rule change request and invites first round submissions from stakeholders	3 November 2011
AEMC issues notice to extend the time period for making of the Draft Rule Determination on the consolidated AER and Energy Users' Committee's rule request under section 107 of the NEL	3 November 2011
First round consultation - public forum in Brisbane	23 November 2011
Submissions close on first round consultation	8 December 2011
Second round consultation - AEMC will release a Directions Paper setting out its initial thinking on the rule change proposals	Late February 2012

Milestone	Date
Second round consultation – public forum in Brisbane, Sydney, Melbourne or Adelaide (to be confirmed)	Early March 2012
Submissions close on Directions Paper	Early April 2012
Release Draft Rule Determination on the consolidated rule request on NER	By 26 July 2012
Submissions on Draft Rule Determinations close (at least 6 weeks from release of Draft Rule Determination)	6 September 2012
Release Final Rule Determinations by (within 6 weeks from close of submissions on Draft Rule Determinations)	By 15 October 2012