

19 June 2008

Dr John Tamblyn
Chair
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

Dear Dr Tamblyn

AEMC Rule Change – Energy Users Of Australia’s Request for a Rule Change – Values of Equity Beta and Gamma prescribed in the National Electricity Rules

The Energy Networks Association (ENA) welcomes this opportunity to respond to the Australian Energy Market Commission’s (AEMC) call for comments on the proposed rule change - Values of Equity Beta and Gamma prescribed in the National Electricity Rules.

ENA is the peak national body representing gas and electricity distribution businesses throughout Australia.

Energy network businesses deliver electricity and gas to over 13 million customer connections across Australia through approximately 800 000 kilometres of electricity lines and 75 000 kilometres of gas distribution pipelines. These distribution networks are valued at more than \$45 billion, and each year energy network businesses undertake capital investment of more than \$6 billion in network reinforcement, expansions and extensions.

ENA does not support the proposed Rule change and strongly considers this Rule change to be fundamentally misconceived and should not be progressed.

ENA considers that the proposed Rule change proposal has the potential to undermine the delineation of functions and responsibilities between economic regulatory bodies, energy rule-making bodies and jurisdictional governments and as such undermines the model of market governance established by the Ministerial Council on Energy (MCE) as part of recent energy market reforms.

The proposed Rule change also seeks to reopen in an isolated and unstructured way narrow elements of a package of transitional arrangements determined through an extensive public consultation process which was only finalised in December 2007.

ENA is of the view that a further consequence of the proposed Rule change would be to increase the level of regulatory risk and uncertainty. This risk would stem from the overturning of elements of MCE transitional rules, the introduction of significant questions over the direction of the current market governance model, and the incorporation of parameter values which are at substantial variance to current regulatory precedents.

In particular, ENA considers that the proposed Rule change will create substantial difficulties for the effective and efficient conduct of the Australian Energy Regulator's (AER) Review of Cost of Capital Parameters and Methodologies which is already in its preliminary stages. If the proposed Rule change was progressed it would introduce parallel and duplicative processes to examine detailed cost of capital issues, undermining the intended operation of five yearly cost of capital review arrangements only just put in place by MCE and the AEMC.

ENA further elaborates on these numerous difficulties in the attachment.

Overall, ENA submits that the proposed Rule change is 'misconceived' and should not be progressed. Further, ENA considers that the appropriate forum for all substantive matters is the Australian Energy Regulator's (AER) Review of Cost of Capital Parameters and Methodologies.

Should you have any queries in relation to the above please do not hesitate to contact me.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'ABlyth', followed by a period.

Andrew Blyth
Chief Executive



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ENA Submission

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1. SUMMARY

The Energy Users Association of Australia (EUAA) has proposed amendments to values of key cost of capital parameters currently prescribed in *National Electricity Rules* which will apply to NSW and ACT electricity distribution businesses and electricity transmission businesses.

Under the National Electricity Law the AEMC has the task of considering whether the rule change should be progressed and has the power to decline to progress a rule change it considers misconceived or lacking in substance.

ENA strongly considers this rule change is fundamentally misconceived and should not be progressed as it does not promote the national electricity objective. The rule change application is misconceived and would undermine the national electricity objective because it:

- undermines the established market governance model by seeking to have the AEMC supplant the transitional arrangements recently developed by a transparent public process agreed by the Ministerial Council on Energy (Section 3.1) ;
- would introduce parallel and duplicative processes examining the merits of detailed cost of capital issues, undermining the intended operation of five yearly cost of capital review arrangements only just put in place by MCE and the AEMC (Section 3.2) ;
- creates significant regulatory risk and uncertainty (Section 3.3)

Energy network businesses consider that these factors clearly indicate that the EUAA rule change proposal is misconceived and fails to meet the rule making test contained in the *National Electricity Law*.

For these reasons, the proposals should not be progressed.

2. BACKGROUND

2.1. RULE CHANGE PROPOSAL – VALUES OF BETA AND GAMMA

The EUAA rule change proposal seeks to amend general rule provisions relating to establishing a cost of capital estimate for electricity transmission businesses, and specific transitional Electricity Rules made for electricity distribution networks operating in New South Wales and the ACT.

The change sought is to substitute new values, which are argued by EUAA to be superior estimates, for the currently prescribed values for two key cost of capital input parameters, equity beta and gamma. The rule would prescribe that an equity beta of 0.75 and a gamma value of 1.0 should apply to a number of revenue and pricing determinations due prior to currently scheduled AER review of cost of capital values and methodologies.¹

The rule change proposal contends that the values prescribed in current electricity transmission rules and transitional rules for NSW and ACT electricity distribution networks rules do not represent a ‘best estimate’.

2.2. RULE-MAKING PROCESS AND FRAMEWORK

The *National Electricity Law* (NEL) establishes the rule making process and framework for the consideration of changes to the *National Electricity Rules*.

2.2.1. Threshold rule change requirements

Under Section 94 (1) (a) of NEL the AEMC must consider whether:

the request for the Rule appears to—

- (i) contain the information prescribed by the Regulations; and*
- (ii) not be misconceived or lacking in substance;*

In determining whether a rule change request is to be progressed, the AEMC is directed to consider whether the subject matter of the rule appears to relate to the subject matter of:

A Rule made, or a request for the making of a Rule under Section 91(1) not proceeded with, in the twelve months immediately before the date of making of that Rule or request...²

¹ Noting that the AEMC is also currently considering an AER proposed rule change which is supported by energy distribution and transmission network businesses aligning the expected completion date for these reviews at 31 March 2009.

² National Electricity Law, Section 94 (1) (c) (i)

This provision appears designed to make clear the power of the AEMC to dismiss rule change proposals which seek to reopen issues settled by completed rule-making processes. The provision raises the potential for the AEMC to take into account the formal Ministerial ‘making’ of the transitional rules taking effect from 1 January to determine that it is not appropriate for a rule change covering these matters to be further progressed.

2.2.2. Rule making test under the National Electricity Law

In order for a new rule to be approved by the AEMC it must be satisfied that the change is likely to contribute to the achievement of the National Electricity Objective, which states that the objective of the National Electricity Law is to:

...to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- (a) price, quality, reliability and security of supply of electricity; and*
- (b) the reliability, safety and security of the national electricity system*

Thus three relevant factors for consideration for the AEMC through initial consultation are:

1. whether the rule change appears misconceived or lacking in substance;
2. whether the rule changes relates to subject matters of a rule already made in the last twelve months ;and
3. the prospect of the rule change satisfying the rule change test (to further inform the analysis of 1).

3. ISSUES RAISED BY PROPOSED RULE CHANGE

ENA considers that the proposed rule change is misconceived due to its inconsistency with the market governance model, its effects on the scheduled AER cost of capital review process, and its impact on regulatory certainty.

3.1. INCONSISTENCY OF RULE CHANGE WITH MARKET GOVERNANCE

The proposed Rule change would distort and undermine market governance arrangements applying to the regulated energy sector. This arises due to the potential for the rule change to lead to the AEMC overturning significant elements of the transitional rule arrangements recently developed through an extensive and time consuming process of public consultation and determined by the Ministerial Council of Energy to be appropriate for New South Wales and ACT.

3.1.1. Development and purpose of transitional rules

Transitional arrangements were established to provide certainty and clarity to the market and regulated electricity distribution network businesses where regulatory price and revenue determinations were effectively being commenced prior to the settlement of uniform National Electricity Rules applying to the economic regulation of distribution services. The transitional rules were developed and consulted on through working groups involving input from jurisdictional governments, the AER, AEMC and representatives of energy users.

These transitional rules include the fixing of a number of key cost of capital parameters, including benchmark equity beta and gamma values. This package of MCE transitional rules were released in November 2007, agreed by Ministers, and took effect from 1 January 2008 following their formal endorsement by the South Australian Energy Minister.

ENA does not consider it appropriate for the AEMC to supplant these recently established and widely consulted on transitional rules.

3.1.2. Responsibility for and authority over transitional arrangements

A key reason the proposed rule change is misconceived is because it seeks to reopen specific elements of Ministerially determined transitional rules for effective review under the AEMC rule change process. This rule change invites the AEMC to amend the substantive *content* of transitional rules impacting on regulated businesses currently undergoing price and revenue determinations under the transitional rules.

This represents an unprecedented potential extension of the function and scope of the rule change process, and is completely inconsistent with the market governance model under which initial Electricity Rules, transitional arrangements and policy determinations were made by agreement between jurisdictions with MCE Ministers as final decision-makers, based on outcomes of preceeding public consultation.

At a Ministerial level this policy intent was most recently reiterated by the MCE December 2007 Communique:

Ministers also noted the finalisation and MCE approval of the amendments to the National Electricity Rules and the amendments to the National Electricity Law Regulations. The amended rules transfer distribution regulation to the AER and set out the framework for the regulation of electricity distribution networks. The amended rules also contain appropriate transitional arrangements to deal with the transition to the national framework and the ongoing regulation of the current distribution determinations.³

The purpose of the transitional rules being developed by MCE was to provide a greater level of certainty than the expected initial rules, given that the price and revenue determination processes in NSW and ACT were occurring in parallel to the finalisation of generic rules. The proposed rule change would, if progressed, frustrate that policy objective.

3.2. IMPACT ON AER COST OF CAPITAL REVIEW PROCESS

The proposed rule change would also have negative impacts on the effectiveness, efficiency and procedural independence of the currently scheduled AER review of cost of capital values and methodologies.

Individually these negative impacts are significant enough to warrant the rule change being dismissed as misconceived. Taken collectively, they are so serious that they are sufficient to make the rule change proposal completely unworkable and misconceived.

3.2.1. Creation of dual processes

The proposed Rule change as it currently stands would involve the AEMC and the AER being engaged in parallel processes through the second half of 2008 examining the detailed merits of the adoption of particular values and methodologies relating to cost of capital estimation.

This would be confusing and resource intensive for network businesses, the AER, and other participants and foster wasteful duplication. Such a confused and uncertain set of competing processes would be at odds with the intention of the AEMC and MCE in establishing regular five yearly reviews.

Such an outcome would likely prevent the realisation of a significant part of the efficiency benefits from economies of scope and scale that led both AEMC and the MCE to favour establishing single comprehensive processes to set default or prescribed cost of capital parameter values and methodologies across regulated electricity distribution and transmission infrastructure.

³ Ministerial Council on Energy, 14th Meeting Communiqué, 13 December 2007

3.2.2. Impacts on effectiveness of AER review processes

The rule change would also have detrimental impacts directly on the AER’s announced cost of capital review, which is scheduled to enter its first consultative phase over the coming weeks.

The progression of this rule change proposal to a further consultation and draft determination phase would place the AER in an extremely difficult position regarding market perceptions of the procedural independence of its cost of capital review by introducing significant doubt over whether elements of the review would in fact be overturned by any final AEMC rule determination.

Importantly, the change would also prevent the AER being able to carefully examine and implement findings around the cross-linkages between the equity beta and gamma values and other parameters which fall outside the scope of the EUAA rule change.⁴

3.3. IMPLICATIONS FOR REGULATORY CERTAINTY

A further reason the proposed Rule change is misconceived is that it does not promote the National Electricity Objective.

The focus of the EUAA rule change proposal is to:

- review important elements of MCE agreed transitional rules which are currently the basis for regulatory price reviews already underway in NSW and the ACT, where formal regulatory proposals have already been lodged; and
- seek to re-open the values prescribed in the AEMC’s November 2006 final determination on electricity transmission rules, a determination which laid out a specific method and timeline for comprehensively reviewing these values by the AER

The proposed rule change has the potential to create significant longer term risk and uncertainty around energy regulatory arrangements applying to electricity transmission and distribution businesses.

It is difficult to conceive how such risks would ‘*promote efficient investment electricity services for the long term interests of consumers*’. While the rule change could potentially result in short term price falls to some existing consumers, the economic impact of the creation of these additional risks are likely to result in a higher long term cost of capital applying to regulated energy infrastructure generally, offsetting any short term gains in consumer welfare from reductions in access charges.

The regulatory risk that would be created were these two elements of the change progressed is not substantively addressed by the EUAA.

⁴ For example, the relationship of the gamma value and the historical measurement of the market risk premium has been an issue in previous regulatory cost of capital reviews and is likely to be examined as part of the AER cost of capital review .

3.3.1. Sources of regulatory risk in rule change

If the AEMC was to agree to review elements of MCE agreed transitional rules, and reopen elements of a final Rule determination made in late 2006, this would create *materially* higher regulatory risk. This is because it would:

- indicate a fracturing of a widely understood market governance model established by the Ministerial Council on Energy;
- impact on the operation and practical effect of AER reviews of cost of capital parameters and methodologies;
- suggest that a wide range of recent Rule determinations could potentially be subject to reopening, raising the prospect of significant alterations to the operational rules and risk characteristics of the National Electricity Market;
- raise the potential for other changes to be proposed or progressed which would alter the transitional rules the AER must apply in NSW and the ACT despite regulatory reviews already being commenced;
- establish a precedent for cost of capital values applying to distribution and transmission network businesses being altered and adjusted on an *ad hoc* basis through time through the general rule-making process; and
- would significantly alter the basis of future AER determinations in respect of cost of capital parameters and values in a way which impacts on electricity transmission and distribution networks valued at approximately \$40 billion⁵

The proposed Rule change fails to address these significant issues of regulatory risk.

⁵ This would occur by virtue of both the electricity transmission and distribution rules providing for future reviews on cost of capital issues to take into account values currently applied or contained in previous decisions.

4. CONCLUDING REMARKS

A strong case exists for the EUAA proposed Rule change not to be progressed, and to be determined as misconceived under the AEMC’s rule making framework.

The EUAA rule change seeks to redetermine some narrow but significant elements of recent policy and rule determinations collectively made by Australian Governments and the AEMC over the past two years. One of the strengths of recent energy market reforms has been the clearer delineation of the role of market and regulatory bodies, and the establishment of the MCE as the clear policy making body responsible for progressing the transition to national economic regulation of energy distribution networks.

This response highlights the potential risk of the proposed Rule change proposal undermining this clear and effective market governance model. An additional potential impact of this rule change proposal could be to harm the efficiency and effectiveness of single clear and comprehensive AER review process to determine appropriate cost of capital values and methodologies to apply to electricity distribution and transmission businesses, by lifting out isolated elements of this review for consideration through an AEMC rule change process not designed for such a task.

Overall, ENA submits that the proposed Rule change is ‘misconceived’ and should not be progressed. Further, ENA considers that the appropriate forum for all substantive matters is the Australian Energy Regulator’s (AER) Review of Cost of Capital Parameters and Methodologies.

1 February 2008

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