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27 January 2012

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Consultation Paper on *Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets* Rules

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the AEMC on its Consultation Paper on *Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets* Rules.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 38 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 61,000 people and contribute $19.3 billion directly to the nation's Gross Domestic Product.

The Major Energy Users have proposed Rule changes to both the National Electricity Rules and the National Gas Rules. These changes would require the AER to:

a) review the valuation of all assets at each periodic review to ensure that the value of the assets reflects the minimum value necessary to ensure the provision of the services required, and;

b) ensure that the cost of replacement of assets can only be recovered if the asset being replaced cannot be used productively for further service.

As the AEMC's consultation paper explains, the key criterion for accepting the proposed Rule changes, or indeed making a more preferable Rule, is that they better satisfy the National Electricity and National Gas Objectives than the current Rules. These objectives are set out below.

National Electricity Objective: "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, safety, reliability, and security of supply of electricity; and

b) the reliability, safety and security of the national electricity system."

National Gas Objective: "to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

The Association considers that the Rule change Proposals fail to promote the Objectives. Firstly, the analysis put forward by the proponents fail to demonstrate that there is a problem that needs fixing - no evidence is given of energy networks discarding assets prematurely and the existence of incentive frameworks that drive efficient investment decisions is not given consideration. Secondly, they introduce a new and substantial element of regulatory risk to the regulatory frameworks for energy networks – that is, the ex post recalculation of the regulatory asset base (RAB). Other things being equal this would lead to a higher cost of capital for networks which ultimately would require consumers to pay more for network services. Finally, they add to the regulatory burden not just for the networks, but for other stakeholders including the regulator itself. Again, this has cost implications, the burden of which would ultimately fall to consumers. These points are expanded on below.

Is there a problem that this Rule change proposal addresses?

The proponents of the Rule changes argue that there is an incentive to overinvest in the network, specifically to replace assets sooner than required, to replace assets that are fully depreciated on the basis that they no longer earn a return and to invest in assets larger than necessary. In all instances, these arguments fail to acknowledge the basic form of incentive-based regulation embodied in the National Electricity and Gas Rules. This is based on an ex ante review of expenditure proposals by the regulator and then the network business is expected to manage its network and meet its obligations and service standards on a fixed amount of revenue for five years. Typically, if it has to spend more than expected to do this it bears a portion of the extra cost and if it can do so more cheaply it retains a portion of the savings. Under this model, the business makes more money if it can retain an asset in service for longer than expected regardless of whether there is any RAB that can be related to that asset, because it can defer the replacement cost. It also makes more money if it considers that it can build a smaller rather than a larger asset to meet its requirements. Accordingly, the incentives are essentially the *opposite* of those alleged by the proponents.

Similarly, if at the time of the price control review the network proposes asset replacement expenditure that is excessive or premature, then the regulator has the right to disallow it and the network will not be allowed to recover revenue to pay for this expenditure.

Some parties have raised concerns about how well this framework is working in practice and the regulator has proposed a number of rule changes to address those concerns. While the Association does not support these rule changes, that process is the appropriate way to consider such issues.

The importance of regulatory certainty

Network businesses are inevitably highly capital-intensive businesses that must regularly access capital markets for both new capital and refinancing. It is critical that the providers of finance have confidence in the stability and predictability of the regulatory framework that governs the cashflows the businesses can earn so that finance can be accessed at least-cost. This regulatory certainty is best achieved by having a clear governance framework and a clear understanding of how the regulator interprets and applies the Rules under which it operates. As such any changes to the Rules run the risk of undermining this regulatory certainty, especially where they create, through affording the regulator new powers of discretion, ambiguity about how these rules will be applied.

This is particularly the case with any proposal to reopen the value of the RAB. Since the RAB is a key driver of future cashflows, it is essential that investors have confidence that once agreed by the regulator, any additions to the RAB are carried forward and can earn a return over their economic life. The proponents' proposed Rule changes essentially places this at risk. This will have a direct impact on investors' required cost of capital, which will in turn lead to higher costs for consumers.

Increasing the regulatory burden

The Rule change proposal introduces a requirement for the regulator to carry out a whole new set of analysis on the RAB, a significant and complex undertaking. The networks themselves would have to invest greater resources in the regulatory process in order to satisfy the terms of the Rule change, and other stakeholders would also be affected if they wished to engage in the process. This would add significantly to the cost of the regulatory process.

In short, it is clear that the proposed rule changes would fail to serve the long term interests of consumers, given that they would make the supply of electricity and gas *more* costly and distort incentives for efficient decision making by network businesses.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9670 0188.

Yours sincerely

Matthew Warren
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