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Dr John Tamblyn  
Chairperson  
Australian Energy Market Commission  
Level 16, 1 Margaret Street  
SYDNEY NSW 2000

Dear Dr Tamblyn

Thank you for your letter of 16 February 2006 providing the opportunity to comment on the Australian Energy Market Commission's (AEMC) proposal to amend the National Electricity Rules governing the regulation of transmission revenue and prices.

Under the National Electricity Law the AEMC is required to have regard to the national electricity market objective – to promote an efficient, reliable and safe electricity system in the long term interests of consumers. While the AEMC needs to be mindful to find a balance between minimising prices to customers and ensuring businesses have sufficient resources to meet customer needs. In regard to reliability and security, the Government considers that the proposed Rule changes appear to be weighted too heavily in favour of the interests of Transmission Network Service Providers (TNSPs) and is therefore, on balance, unlikely to be in the long term interests of consumers.

The State Government considers that the highly prescriptive Rule changes being proposed by the AEMC may unduly limit the discretion the regulator has in its decision making powers. While the intent of the propose-respond model, including codification of the parameters used in the calculation of the weighted average cost of capital (WACC), is to provide greater regulatory certainty, this greater prescription may systemically favour TNSPs over consumers in certain circumstances. For example, where the WACC parameters are tending to decrease over time, then market evidence will suggest there should be an adjustment downwards. This will not be possible under the proposed Rules where the WACC parameters are codified for 5 years or more by the AEMC.

The requirement placed on the Australian Energy Regulator (AER) to accept a TNSP's proposed forecast capital and operating expenditure, where it is a 'reasonable estimate' having regard to a number of specified criteria, appears to be a significantly lower hurdle than the current requirement for 'efficient' expenditure.

Section 16(2) of the National Electricity Law requires that when making a transmission determination, the AER must allow the system operator to recover the efficient, rather than reasonable, costs of complying with its regulatory obligation.

As has been demonstrated in many revenue determinations, expenditure estimates by network businesses have tended to significantly overestimate expenditure requirements and they have subsequently underspent on regulators' efficient expenditure allowances.

On the subject of parameters to be used in the calculation of WACC, the State Government notes that the Draft Rule proposes that an equity beta of 1.0 be codified in the Rules. Professor Martin Lally of the Victoria University of Wellington, New Zealand, has previously advised the South Australian Government that there was evidence to suggest that the use of an equity beta of no more than 0.8 was justified based on his analysis of equity betas of regulated monopolies, including gas distribution businesses. Some studies of recent market data suggests that an equity beta for Australian utilities of substantially lower than 1 (possibly as low as 0.5) may be reasonable.

The equity beta of 1.0 appears to be based on the *Statement of principles for the regulation of electricity transmission revenues – background paper* (page 108) published by the Australian Competition and Consumer Commission (ACCC) in 2004.

It needs to be recognised that the ACCC's decision to adopt an equity beta of 1.0 in the near term was clearly qualified. The ACCC indicated that it would continue to exercise judgement in the application of empirical market evidence and would undertake further work in this area. The Draft Rule does not allow for any flexibility or further consideration and would appear to apply for a much longer period than originally envisaged (until 1 July 2011). The codification of an equity beta of 1.0 limits the discretion of the regulator to revise the decision, even in the face of strong market evidence.

The Draft Rule also proposes the market risk premium be deemed to be 6%. Recent work undertaken by the South Australian Centre for Economic Studies concluded that a market risk premium in the region of 4.5% to 5% was more appropriate.

The Government considers that the proposed BBB credit rating is inconsistent with the proposed benchmark gearing ratio of 60 per cent, which suggests a credit rating of BBB+ or higher. Previous regulatory decisions, including the ACCC's 2002 decision in relation to ElectraNet, assumed an A credit rating for the same gearing ratio.

In relation to the proposed ex-ante framework to be applied for the assessment of the investment programs proposed by the TNSP as part of establishing the revenue requirement, the State Government considers that there must be a detailed assessment of a TNSP's proposed capital program if an ex-ante framework is to be applied. In particular, there must be a clear requirement that TNSPs must work within the Regulatory Test framework and there is an ex-post prudency review at the next reset prior to roll in.

It is also considered that although the AER should still retain some discretion in relation to depreciation, guidelines on what constitutes an economic life should be developed in order to remove the incentive for the TNSP to rapidly depreciate assets to gain increased short term returns from higher prices to consumers.

While transmission charges account for only a small proportion of the final bill paid by consumers, regard must be had to the affect on consumers if the proposed Rules were to be adopted in relation to distribution prices, which account for around 40 per cent of the final bill to consumers.

While the State Government considers that a revenue cap approach may be appropriate in the case of electricity transmission revenue regulation, it is considered that a revenue yield approach, as currently applies in South Australia, is more appropriate in the case of electricity distribution revenue regulation. A revenue yield approach provides more flexibility to accommodate risks if growth is greater than expected, as was demonstrated in previous NSW revenue determinations.

Thank you for the opportunity to make a submission to this stage of the Rule change process.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Jay Weatherill', written in a cursive style.

Hon Jay Weatherill MP  
**A/MINISTER FOR ENERGY**

4/4/2006