

ECONOMIC REGULATION AUTHORITY SUBMISSION TO THE AEMC

AEMC Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006

INTRODUCTION

The Western Australian Economic Regulation Authority (“Authority”) is pleased to make this submission to the Australian Energy Market Commission (“AEMC”) on the AEMC’s Transmission Revenue Rule Proposal (“Rule Proposal”).

While the Transmission Revenue Rule will not have effect in Western Australia, for which economic regulation of electricity transmission services is undertaken under a State-based regime, the Rule may affect regulation of infrastructure services in Western Australia through:

- making changes to an Australian regulatory regime that may establish a precedent for the revision and implementation of regulatory regimes that have effect in Western Australia, particularly the National Gas Code that is currently the subject of a process for revision;¹ and
- codifying a number of elements of the service-price offerings of infrastructure service providers that were previously subject to determination by the regulator according to a discretionary process, and which may become relevant precedents for regulatory determinations in Western Australia.

The Authority has limited its submission to addressing three broad elements of the Rule Proposal that it considers may have particular precedent value in the future revision and/or implementation of regulatory regimes throughout Australia.

1. The framework that the AEMC is proposing to establish for regulatory decision making for electricity transmission and, in particular, the procedural and timing requirements that the AER will be required to follow when making a determination on transmission prices.
2. The guidance that the rule would provide to the AER when it makes a determination on transmission revenues, in particular, the codification of the “propose-respond” model of regulation and the nature of appeal mechanisms that, together, affect the way in which a regulated entity participates in a regulatory determination and affect the potential for systematic bias in determinations.
3. The codification of matters previously the subject of discretion by the ACCC/AER, particularly the key inputs to calculation of the regulatory rate of return.

FRAMEWORK FOR REGULATORY DECISION MAKING

Division 4, Subdivision 1 of the Rule Proposal sets out a process for a “revenue cap determination” in respect of a transmission network service provider. The process specified in the Rule Proposal represents a substantive change to the National Electricity Rules by introducing the following elements:

¹ A central element of the Ministerial Council on Energy’s energy market reform program is to establish a common approach to transmission and distribution revenue and network pricing across both electricity and gas. Determining a model to achieve this has been the principal role of the Expert Panel appointed by the MCE, which released its draft report on 10 March 2006 (Expert Panel on Energy Access Pricing, March 2006, Draft Report to the Ministerial Council on Energy).

- A right and obligation of the service provider to submit a proposal at the commencement of the process, whereas under the current National Electricity Rules there is no such right or obligation.
- Explicit requirements for the process of the revenue cap determination to include consultation, a draft decision and a final decision.
- Explicit requirements for the publishing of reasons for draft and final decisions.

In addition, the Rule proposal establishes a maximum time period of 13 months for a revenue cap determination, and establishes maximum time periods for the various components and phases of the determination process.

The Authority notes that the process set out in the Rule Proposal for a revenue cap determination is broadly similar to the process established for a regulator's assessment and approval of a proposed access arrangement, or proposed revisions to an access arrangement, under section 2 of the National Gas Code. The Authority (and its predecessor the Western Australian Independent Gas Pipelines Access Regulator) has had substantial experience in approvals under section 2 of the National Gas Code and supports the process for assessment and approval of access arrangements. The Authority considers that the process of draft and final decisions, and opportunities for consultation, is consistent with broad requirements for procedural fairness in the making of regulatory determinations and considers that this substantial experience with the process has resulted in it becoming known and accepted by stakeholders in regulatory determinations.

The Authority considers, however, that establishing a maximum time period for a revenue cap determination may be problematic for reasons that:

- where a service provider or other relevant party withholds information that the AER may require for the making of a determination, significant delays in the process may occur where the AER has to resort to compulsory powers of information acquisition, particularly in circumstances where a service provider or other party has a right of appeal over the exercise of these powers or over a decision by the AER to publicly release information;
- where, after an initial submission of a revenue proposal, a service provider submits changes to its proposal or further information, the AER may find it necessary to extend periods of consultation to allow interested parties to make submissions on the relevant changes or further information; and
- where new information becomes available to the AER during the course of a determination, particularly subsequent to a draft decision and related submissions, which would cause the AER to make a significant alteration of its determination and, for reasons of procedural fairness, may require the AER to engage in further consultation with either the service provider or other stakeholders that would be affected by the alteration.

The Authority therefore submits that, if the AEMC establishes a maximum time for a revenue cap determination, that consideration be given to the problems that this might create for obtaining information relevant to the determination and for procedural fairness. In particular, the Authority considers that the AEMC should give consideration to:

- providing explicit guidance to the AER as to the process, functions and powers in the making of a revenue cap determination in circumstances where the service provider fails to provide adequate supporting information in support of certain elements of the service provider's proposal;
- the circumstances in which it may be necessary or desirable to suspend the timing of a transmission determination, and the process by which such a suspension may be implemented.

GUIDANCE FOR A REVENUE CAP DETERMINATION

The Rule Proposal establishes particular requirements for the AER's consideration of, and determination on cost forecasts underlying a revenue proposal. In particular, the AER would be required to accept a service provider's proposed forecasts of capital expenditure and operating expenditure where these forecasts are reasonable estimates of the expenditure requirements, having regard to a range of specified criteria (clause 6.2.6 and 6.2.7).

The Authority notes that the Expert Panel appointed by the Ministerial Council on Energy has given considerable attention to these requirements under the proposed rule in the context of considering the broad "model" of regulation. The Expert Panel has taken the view that these requirements are consistent with a "propose-respond" model of regulation similar to that established under the WA Electricity Code (explicitly) and the National Gas Code (as the Gas Code has been interpreted since 2003). The Expert Panel has also taken the view that this model of regulation establishes a presumption in favour of accepting a service provider's proposal and may lead to a systematic increase in the returns to service providers relative to a conventional "consider-decide" model of regulation.² This may occur by creating an incentive for service providers to make ambit claims of forecast costs in revenue proposals in order to discover the AER's bounds to a range of reasonable forecasts, and then for the service provider to re-submit the revenue proposal with forecasts at the upper bound of this range. Moreover, the Expert Panel concludes that the propose-respond model may militate against consistency across regulatory determinations.³

The Expert Panel notes that a number of parties have sought to justify the desirability of a propose-respond model of regulation by arguments that the model is necessary to reduce regulatory risks to service providers and avoid potential for under-investment in energy infrastructure.⁴ The Expert Panel concludes, and the Authority concurs with these conclusions) that the contentions of these parties are largely unsupported by evidence. The Authority suggests the AEMC should take into account that revision of regulatory frameworks is itself a potential source of regulatory risk, and that the need for change should be rigorously demonstrated.

To the extent that the existing regulatory schemes for gas and electricity infrastructure may potentially give rise to regulatory risk for service providers, the Expert Panel concludes that there are more appropriate mechanisms for addressing the potential for regulatory risk. In particular:

- requiring that the AER accord weight to the service providers proposal in making a determination, but not establishing the presumption in favour of approving the service provider's proposal; and
- ensuring that there exists a well-designed process for merits review of regulatory determinations.⁵

The Expert Panel further concluded that, if the approach that is being taken by the AEMC in the Rule Proposal for determinations on cost forecasts were to be maintained and more broadly applied in access regulation, consideration should be given to mechanisms to "reduce the options for 'gaming' the decision making process by reducing the incentive to

² Expert Panel on Energy Access Pricing, March 2006, Draft Report to the Ministerial Council on Energy, pp 68, 69.

³ *Ibid.* p 77.

⁴ *Ibid.* pp 68 – 76.

⁵ *Ibid.* p 77.

use initial proposals as a means of establishing the AER's assessment of the range of a reasonable estimate".⁶

The Authority submits that, in further making its draft and final determinations on the Rule, the AEMC should take into account the reasoning and conclusions set out in the Expert Panel's draft report.

The Authority also submits that the AEMC should give particular consideration to the prospect that a merits review process may be introduced under the National Electricity Law for determinations of the AER under the Rule and, in the case that this occurs, whether the presumption under the Rule Proposal for accepting a service provider's cost forecasts is necessary or desirable. In particular, the Authority submits that the AEMC should consider whether the presumption in favour of accepting a service provider's cost forecasts is an unnecessary protection of the interests of the service provider in circumstances where the framework for regulation establishes clear principles to guide a regulatory determination, and where there is a well designed merits review process.

CODIFICATION OF CERTAIN ELEMENTS OF REGULATORY DETERMINATION

The Rule Proposal codifies certain elements in a revenue cap / price determination for electricity transmission activities (set out in clause 6.2 of the Rule Proposal) including the form of regulation (post-tax revenue model), the methodologies for determining an opening value of the RAB and updating this value, the value of the WACC, the determination of depreciation and the determination of the cost of corporate income tax.

The Authority takes the view that there are a number of elements of regulatory determinations on which a range of standard methodologies and assumptions have developed, independently of any explicit requirements under regulatory codes. These include approaches and assumptions for:

- determination of rates of return, in particular the use of the CAPM methodology and the application of standard assumptions for parameters such as gearing levels, the market risk premium, risk free rates of return and forecasts of inflation, the equity beta and the value of tax imputation;
- roll-forward calculations for regulatory asset values; and
- calculation of depreciation schedules.

The Authority also notes that particular regulators have individually adopted standard methodologies to determine revenue requirements, including the form of regulation (pre-tax or post-tax revenue models), assumptions as to the timing of costs and revenues, and the treatment of working capital.

Where standard methodologies and assumptions in regulatory determinations have emerged, the Authority supports the codification of these under the Rule as a means of promoting certainty in regulatory processes and reducing the cost of determinations, subject to periodic reviews of the standard approaches and assumptions.

The Authority considers, however, that the codification of approaches and assumptions should not occur to the extent that there is undue restriction on the AER in dealing with specific situations on their merits. In particular, the Authority considers that there may be merit in retaining flexibility in matters such as:

- the determination of depreciation schedules, with a capacity to alter depreciation schedules to reflect long-term forecasts of demand and asset utilisation; and

⁶ *Ibid.* p 82.

- the design and parameters of incentive schemes for the achievement of cost efficiencies and service improvements, for which it may be appropriate to set parameters to reflect the potential for, and value of, efficiency and service improvements in particular circumstances.

The Rule Proposal includes a specification of methodologies and parameter values for the determination of a regulatory rate return (clause 6.2.4), with a requirement that the AER review these methodologies and parameter values at five-year intervals. The Authority submits that there are two matters that the AEMC should give further consideration to before making its draft and final determinations.

- Several recent regulatory determinations, particularly under the National Gas Code, have considered ranges in parameter values in determining the cost of capital. The parameter values specified in the Rule Proposal tend to be at or close to the upper bounds of the ranges of parameter values contemplated in recent regulatory determinations. The AEMC may wish to give further consideration to whether these values are unduly in the favour of the service providers.
- While the methodologies and parameter values specified in the Rule Proposal are, for the most part⁷ consistent with the ranges of values contemplated in recent regulatory decisions in Australia, the Authority submits that there may be merit in the responsibility for establishing the methodology and parameter values to reside with the AER (as the regulatory decision making body), rather than the AEMC, and the determination of the methodologies and parameter values being given detailed consideration before being established for a five year period.

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⁷ The exception of the value to be assumed for the credit rating, for which clause 6.2.4(d) specifies a credit rating assumption of BBB, while the vast majority of recent regulatory determinations for regulated energy infrastructure have applied a credit rating of BBB+.