INFORMATION

Network regulation rule changes directions paper: 2 March

AEMC issues directions paper

The AEMC today issued a directions paper on rule change requests from the Australian Energy Regulator (AER) and a group of large energy users (EURCC). These rule change requests seek to change the way revenues are set for electricity and gas network businesses. The directions paper sets out the AEMC's initial positions on the issues, as well as its next steps.

Overview of AEMC initial position

The Commission agrees that some areas of the National Electricity Rules could benefit from enhancement, principally related to how the regulated asset base is determined, how the rate of return is set, and the process for making determinations. In some of these areas, while the rule change requests propose solutions, the Commission will explore other options for making these enhancements. In the next period, the AEMC will be working to understand the issues better and to develop the best solutions to address them. The AEMC will be seeking further input of stakeholders.

The AER's gas rule change request covers only how the rate of return is set. Unlike electricity, this also applies in Western Australia. The Commission will consider whether any enhancements could be made to these provisions for gas.

Public consultation

Consultation on the rule change requests commenced in October/November 2011 when the AEMC published two consultation papers. In total, 65 submissions were received on these consultation papers.

The Commission is now seeking submissions on its directions paper.

Submissions close on 16 April 2012. The Commission will consider these submissions and undertake further analysis, including by way of external consultants, before publishing a draft determination in late July 2012. This may include a draft rule.

Other consultation activities will include a workshop-style public forum, on 2 April 2012, and focused consultation on rate of return issues.

Overview of issues raised

The most significant factors that determine the revenues earned by electricity network businesses are the size of the business's asset base and the rate of return on capital. For electricity the rule change requests relate to how the AER approves (or rejects) proposed additions to the asset base, and how the rate of return is set. The overall process by which the AER interacts with stakeholders to make these decisions is also covered.

In respect of gas, the rule change requests only relate to how the rate of return is set.

These issues are set out in more detail below, along with the Commission's initial position on them.

AUSTRALIAN ENERGY MARKET COMMISSION LEVEL 5, 201 ELIZABETH STREET SYDNEY NSW 2000
T: 02 8296 7800 E: AEMC@AEMC.GOV.AU W: WWW.AEMC.GOV.AU

Rate of return (electricity and gas)

The rules allow for electricity network service providers (NSPs) and gas service providers to earn a return on their investments. There is a different approach to determining this return in electricity distribution, electricity transmission and gas. The AER proposes that the three sectors move to a single approach which most closely aligns to electricity transmission, in which there are periodic reviews of the rate of return parameters, which are then fixed for each NSP or gas service provider.

The Commission's view is that the current rules for electricity transmission are not satisfactory. The rate of return framework for electricity transmission does not provide sufficient flexibility to adapt to changing circumstances. The gas and electricity distribution frameworks are preferable in this regard. In addition, these frameworks allow for merits review of rate of return decisions which, on the basis of the current merits review mechanism in the law, is appropriate given the impact of the rate of return on network prices. The Commission's preference is for a single framework to apply across all three sectors but it will consider different frameworks for electricity and gas. The Commission's preliminary view is that the rate of return framework should not prescribe the methodology or values for parameters that should make up the rate of return allowance, but rather provide guiding principles that the regulator should apply.

One component of rate of return decisions is the cost of debt that is designed to reflect the expected costs of regulated businesses for raising debt capital. The Commission agrees with the AER and EURCC that the current approach in the rules is problematic. While an alternative approach proposed by the EURCC has some merit in its proposed adjustment to the benchmark cost of debt, some elements of this represent a fundamental change in approach. In addition, the Commission is concerned that its proposal may be too prescriptive and rigid for inclusion in the rules. However, the Commission is considering whether it would be more practical if the rules provide discretion to the regulator to consider and apply such an approach in the right circumstances.

Finally, the Commission does not consider appropriate the EURCC's proposal for different approaches to the cost of debt for government-owned and privately-owned NSPs.

Capital expenditure (capex) and operating expenditure (opex) issues

Part of the AER's role is to consider, in advance, forecasts of capex and opex which NSPs propose to undertake. If the AER does not approve such expenditure it may replace the forecast with its own estimate. The AER is concerned that the rules restrict its ability to interrogate and amend NSPs' forecasts, and that this means network costs are being set at higher than efficient levels.

The Commission seeks more evidence to understand the drivers of increases in network costs. It proposes to analyse this evidence to determine the extent to which the AER's powers (or lack of such powers) in respect of capex and opex allowances are contributing to these increases. In parallel with this, the Commission will confirm whether the policy settings for capex and opex allowances are consistent with the practices of other regulators in Australia and overseas.

Once a capex allowance is set, NSPs are not prevented from undertaking capex beyond such allowance. After a period of time, any such "overspend" is automatically factored into overall revenues and prices for the NSP. The AER is concerned that this creates incentives for NSPs to incur more than efficient levels of capex. It has proposed a mechanism by which only 60 per cent of such overspend could be included in the asset base.

The Commission takes the view that there may be incentives on NSPs to defer capex, in an inefficient way. In addition, capex above the allowance is not subject to scrutiny, which also creates a risk that it may be inefficient. The Commission shares concerns raised by stakeholders regarding the AER's 60 per cent proposal, and explores in the directions paper a range of other options for dealing with the problems it has identified.

Regulatory determination processes

The AER has raised a number of issues that relate to the ability of stakeholders to engage effectively in the regulatory determination process. Related to this is whether the AER can adequately consider material submitted as part of its process. The Commission shares some of the AER's concerns but considers that as well as specific amendments to the process it is necessary to consider the process as a whole to ensure stakeholders have sufficient opportunity to provide input and the AER has sufficient time for its decisions. Process issues must be considered alongside the other issues raised above.

On 2 March the AEMC issued its directions paper for the network regulation rule changes.

Background

Electricity and gas network businesses transport energy from generators or producers to end use consumers. Transmission businesses transport energy at high voltage or pressure linking generators or producers with load centres. Distribution businesses transport energy at a lower voltage and pressure from points along the transmission network or pipeline to end-use customers. The services they provided also facilitate competition in the generation and retail sectors of energy markets.

Some of these electricity and gas network services are regulated. This means the prices that these businesses can charge and the revenues that they can earn in respect of those services are set by the AER.

The frameworks for the revenue regulation of electricity distribution and transmission services are respectively contained in chapters 6 and 6A of the National Electricity Rules. These electricity rules apply in all eastern Australia states. The framework setting out the price and revenue regulation of certain gas pipelines is contained in Part 9 of the National Gas Rules. These gas rules apply in all eastern Australian states and Western Australia.

The cost of providing network services represents up to half of a customer's bill, and the return on capital represents more than half of the cost of providing these services

For information contact:
Senior Director, **Anne Pearson** (02) 8296 7800
Director, **Richard Khoe** (02) 8296 7800

Media: Communication Manager, Prudence Anderson 0404 821 935 or (02) 8296 7817

Date: 2 March 2012