

30 November 2011

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449,
Sydney South NSW 1235

Dear John

Re: Proposed Rule Change – Clause 6A.6.4 of the National Electricity Rules

ElectraNet proposes a rule change under section 91 of the National Electricity Law (**NEL**), which provides for correction of the value for γ ("gamma") to be applied in calculating the cost of corporate income tax under clause 6A.6.4 of the National Electricity Rules (**NER**).

The proposed rule change is intended to be a simple one-off amendment to clause 6A.6.4 of the NER to correct for known errors in the value for gamma adopted in the Australian Energy Regulator's (**AER**) determination under the NER of various rate of return and tax parameters that must be applied in making transmission determinations. Without the proposed amendment, clause 6A.6.4 of the NER would require the AER to apply a value for gamma that is known to be erroneous and which the AER has conceded was determined in error. Correction of this known error would promote the National Electricity Objective by allowing for proper account of the value of imputation credits in calculation of the cost of corporate income tax in forthcoming transmission determinations.

A draft of the proposed rule change, including marked amendments to clause 6A.6.4 and a corresponding transitional provision for South Australia, is shown in Attachment B. Attachment A sets out the key issues with the current clause 6A.6.4 and explains how the proposed amendments address those issues consistent with the National Electricity Objective.

ElectraNet is aware that the AEMC is currently dealing with a number of rule change proposals relating more generally to the framework for economic regulation of electricity and gas networks. This proposal is separate from and unrelated to those proposals and only deals with the particular issue that has arisen in relation to the value for gamma to be applied under clause 6A.6.4 of the NER.

Should any further details be required, please do not hesitate to contact Rainer Korte on (08) 8404 7983.

Yours sincerely



Ian Stirling
Chief Executive Officer

Attachment A

ElectraNet Rule Change Proposal - Gamma

1. Summary

ElectraNet proposes a rule change under section 91 of the National Electricity Law (**NEL**), to correct known errors in the value of γ ("gamma") that would otherwise apply to forthcoming transmission revenue determinations, including the determination to apply to ElectraNet during the period 2013-14 to 2017-18.

Chapter 6A of the National Electricity Rules (NER) which applies to Transmission Network Service Providers (TNSPs) requires the Australian Energy Regulator (AER) to continue to apply the value for gamma determined by the AER in its 2009 review of rate of return and tax parameters (2009 Review). This value, of 0.65, must be applied by the AER in determining the corporate income tax allowance in respect of TNSP revenue proposals submitted up to March 2014.

In recent merits reviews before the Australian Competition Tribunal (Tribunal) taken by Distribution Network Service Providers, errors have been found in the AER's determination of gamma in the 2009 Review. In these merits reviews the Tribunal concluded that there was persuasive evidence to depart from the findings of the 2009 Review and ultimately determined that the value for gamma should be 0.25.

It is anomalous that the current rules require a known error in relation to gamma to be perpetuated in future transmission revenue determinations that will, in some cases apply until 2019. The anomaly is exacerbated because it is confined to TNSPs while determinations for other energy networks will be able to adopt a value for gamma that is not affected by the errors that the Tribunal has determined affected the value of 0.65 adopted in the 2009 Review. In these unique circumstances, a once-off amendment to Chapter 6A of the NER is required to correct the known errors in the value for gamma that is prescribed for forthcoming transmission determinations.

The ElectraNet proposal is to amend clause 6A.6.4 of the NER to incorporate the value for gamma determined by the Tribunal and to add a corresponding transitional provision for the forthcoming revenue reset for South Australia. ElectraNet's proposed changes are set out in Attachment B (Proposed Rule).

The Proposed Rule will contribute to the achievement of the National Electricity Objective. In particular, by ensuring that tax costs are correctly recognised, the Proposed Rule will provide appropriate incentives for efficient investment. The counterfactual proposition – that the existing rules are maintained – will prevent recovery of efficient costs by TNSPs and may create incentives for inefficient deferral of investment until the value of gamma is amended.

In terms of the application of the Proposed Rule, it is important to note that:

- The Proposed Rule does not apply retrospectively. It will only apply to future transmission revenue determinations, where the Revenue Proposal is submitted prior to the completion of the AER's next five yearly review of the rate of return and tax parameters, scheduled for 31 March 2014.
- The Proposed Rule is a simple once-off correction of the current prescribed value for gamma and does not undermine or pre-judge the outcome of future AER reviews of rate of return and tax parameters. The Proposed Rule only has the

effect of correcting errors in the AER's 2009 Review, in accordance with the Tribunal's findings.

- The Proposed Rule involves minimal drafting changes that are unrelated to and independent of the matters raised by the AER in its recent rule change proposal.
- The Proposed Rule is a simple correction of the value for gamma to apply in future transmission determinations and does not in any way change the structure of clause 6A.6.4.

2. Background

2.1 Operation of the existing rules

Under clause 6A.5.4 of the NER, one component of the annual building block revenue requirement for a TNSP for each regulatory year is the estimated cost of corporate income tax.

Clause 6A.6.4 of the NER requires that this component be calculated for each regulatory year in accordance with the following formula:

$$ETC_t = (ETI_t \times r_t)(1 - \gamma)$$

where ETI_t is the estimated taxable income for that regulatory year, r_t is the statutory income tax rate and γ (gamma) is the assumed utilisation of imputation credits. Gamma is conventionally calculated as the product of the credit payout ratio (also referred to as the distribution ratio, or F) and the value of distributed credits (theta).

Clause 6A.6.4 deems a value for gamma to be applied for the purposes of this calculation, with this deeming subject to a periodic review of the value for gamma by the AER. The NER provided for the first periodic review to be undertaken by May 2009 (**2009 Review**) and at five yearly intervals thereafter, with the next review to be concluded by 31 March 2014.¹ The value for gamma was originally deemed to be 0.5, and was revised upwards by the AER to 0.65 in its 2009 Review.

Under clause 6A.6.4 of the Rules, the AER *must* apply either the deemed value, or where there has been a periodic review, the value determined in the most recent review of rate of return and tax parameters. This means that in respect of TNSP revenue proposals submitted up to March 2014 (the date of the next review of rate of return parameters) the AER must apply the value for gamma determined in the 2009 Review (i.e. a value of 0.65). To the extent that the value for gamma is revised as part of the AER's next review of rate of return parameters, this revised value will apply to revenue proposals submitted by TNSPs after the completion of that review.

2.2 Determination of gamma in the 2009 Review

In its 2009 Review, the AER determined a value for gamma of 0.65, being the product of a distribution rate of 1 and a value for theta of 0.65. The AER concluded:

"Based on the evidence considered most relevant, reliable, comprehensive and theoretically appropriate, the AER considers that a reasonable estimate of gamma lies in the range 0.57 and 0.74. For clarity it is noted that:

² AER, Electricity Transmission and Distribution Network Service Providers: Review of the Weighted Average Cost of Capital (WACC) parameters, May 2009, page 467.

- A payout ratio of 1.0 has been adopted, consistent with a free cash flow approach to valuation and the Officer WACC framework,
- The lower bound estimate of 0.57 is based on the AER's best estimate of theta inferred from market prices, and
- The upper bound estimate of 0.74 is based upon the AER's best estimate of theta from tax statistics."²

The AER determined that theta (and therefore gamma, given a distribution rate of 1) should be the midpoint between 0.57 and 0.74, being 0.65. The AER concluded its analysis in the following terms:

"In accordance with the NER, the AER considers that a gamma value of 0.65:

- is supported by the most recent available and reliable empirical evidence, which the AER considers is persuasive in support of a change to the existing value, and
- generates a forward looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing prescribed transmission services or standard control services (as the case may be).

In determining the value of imputation credits, the AER has also taken into account the revenue and pricing principles. The AER considers the value of imputation credits of 0.65 for a benchmark efficient NSP:

- together with values, methods and a credit rating for the other parameters, provides a service provider with a reasonable opportunity to recover at least the efficient costs and provides a service provider with effective incentives for efficient investment, and
- is appropriate having regard to the economic costs and risks of the potential framework in under and over investment.

On this basis, the AER considers that its proposed value achieves an outcome that is consistent with and is likely to contribute to the achievement of the NEO [National Electricity Objective]."³

2.3 Tribunal findings in relation to the distributors' gamma appeal

Following the 2009 Review, a number of electricity distributors argued that the value for gamma of 0.65 should not apply to their distribution determinations. Unlike Chapter 6A of the Rules, Chapter 6 provides scope to depart from a value for gamma determined in a periodic review, if there is persuasive evidence justifying a departure.

Electricity distributors in South Australia and Queensland (the first to be subject to the findings of the 2009 Review) argued that there was persuasive evidence to depart from the value for gamma established in the 2009 Review. The AER rejected these arguments and maintained a value for gamma of 0.65 in its distribution determinations for South Australia and Queensland. Each of the Queensland and South Australian distribution businesses sought merits review of the AER's decision in respect of gamma by the Tribunal.

² AER, Electricity Transmission and Distribution Network Service Providers: Review of the Weighted Average Cost of Capital (WACC) parameters, May 2009, page 467.

³ Ibid, pages 468 and 469.

On review, the Tribunal found a number of errors in the AER's decision in respect of gamma in the 2009 Review, including:

- in determining a distribution rate of 1, the AER misconstrued the evidence relating to the long-term distribution rate, particularly the Hathaway and Officer (2004) study which demonstrates that the long-term distribution rate is around 70 per cent;⁴
- in determining a value for theta of 0.65, the AER erroneously took the simple average of a point estimate from a dividend drop-off study (0.57 from Beggs and Skeels (2006)) and an upper bound of 0.74 derived from tax statistics;⁵
- the AER misapplied the findings of the Handley and Maheswaran (2008) tax statistics study, by averaging estimates from two separate time periods to arrive at an upper bound for theta of 0.74.⁶

In respect of the distribution rate, the Tribunal accepted the AER's submission that there was no empirical data before the Tribunal that was capable of supporting an estimated distribution rate higher than 0.7, and concluded that the distribution rate to be applied in determining the value for gamma is 0.7.⁷

In relation to theta, the Tribunal requested that a new 'state-of-the-art' dividend drop-off study be conducted by SFG Consulting based on a methodology that was to be agreed upon by SFG and the AER.⁸ Based on the results of the SFG study which was completed in March 2011 (the 2011 SFG study), the Tribunal concluded that the best estimate of theta is 0.35. The Tribunal found the 2011 SFG study to be the best such study currently available for the purposes of estimating gamma.⁹

The Tribunal also rejected the AER's view that the principle of regulatory inertia justified leaving the value of gamma unchanged at 0.65:

"In its submission, the AER re-agitated one of its earlier arguments: that the Rules establish a regime of regulatory inertia whereby values of the WACC parameter set in the Statement of Regulatory Intent ('SORI') will govern the distribution determinations that are made during the following five years unless, and to the extent that, it is shown that a departure from the SORI values is justified.

The Tribunal accepts that due regard should be given to historical consistency in applying regulatory values over time. Nevertheless, the Tribunal, standing in the AER's shoes, is inescapably required to exercise regulatory judgment in determining the appropriate value of theta.

The Tribunal must determine an appropriate value for gamma on the basis of the material before it. It does not accept that its task is to determine a value of gamma that is appropriate and not too different from the previously determined value of gamma. That gives too little policy weight to the objective set out in s 7A of the NEL that a regulated DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs. That objective must outweigh any presumption of regulatory inertia. In any event, within the SORI framework by which the AER argues

⁴ *Application by Energex Limited (No 2)* [2010] ACompT 7 at [51].

⁵ *Application by Energex Limited (No 2)* [2010] ACompT 7 at [91]-[93].

⁶ *Application by Energex Limited (No 2)* [2010] ACompT 7 at [95].

⁷ *Application by Energex Limited (Distribution Ratio (Gamma)) (No 3)* [2010] ACompT 9.

⁸ *Application by Energex Limited (No 2)* [2010] ACompT 7 at [146]-[148].

⁹ *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9, paragraph 29.

for the principle of regulatory inertia, the Tribunal has persuasive evidence justifying a departure from previously determined values of gamma.”¹⁰

3. Reasons for Proposed Rule Change

3.1 General statement of issues

The existing rules (specifically clause 6A.6.4(f)) ‘lock in’ the value of gamma at 0.65 for TNSPs until the AER concludes its next review of the WACC and tax parameters, which is scheduled for March 2014. Any revision of the value for gamma in the 2014 review will only apply to revenue proposals submitted after the completion of that review.

This means that in the absence of any rule change, a value for gamma of 0.65 must apply to transmission determinations for:

- South Australia, for the period commencing 1 July 2013, until at least 30 June 2018;
- Victoria, for the period commencing 1 April 2014, until at least 31 March 2019; and
- New South Wales and Tasmania, for the period commencing 1 July 2014, until at least 30 June 2019.

It is important to recall that the AEMC established the current rules to provide TNSPs with an environment that will encourage investment:

“Providing short term stability regarding the WACC determination reduces an important source of potential variability in regulatory decision making thereby providing a more certain and predictable environment for investment and financing decision making.”¹¹

However, in circumstances where the locked in value for gamma has been found to be in error, requiring this erroneous value to be applied in future transmission determinations cannot promote the objective of encouraging investment.

A gamma of 0.65 is also inconsistent with the Revenue and Pricing Principles in the NEL which state that a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services. Continuing to apply a value for gamma that is demonstrably too high will lead to an understatement of the cost of corporate income tax in TNSPs revenue allowances and will therefore prevent recovery of efficient costs.

The Proposed Rule will require the AER to adopt a gamma value of 0.25 as determined by the Tribunal, rather than continuing to apply the value of 0.65 determined in the 2009 Review which the AER has conceded is in error. As explained in further detail below, correcting the value of gamma will promote the achievement of the National Electricity Objective.

¹⁰ *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9, [35]-[37].

¹¹ AEMC, Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18, 16 November 2006, page 82.

3.2 Description of Rule change

ElectraNet proposes that a once-off amendment be made to clause 6A.6.4 of the NER to correct known errors in the prescribed value of gamma. This amendment is required to deal with the unique circumstances in which TNSPs now find themselves, where future transmission determinations would otherwise be subject to a gamma value that is known to be erroneous and which the AER has conceded was in error.

It is proposed that clause 6A.6.4 be updated to deem the value for gamma as it has been determined by the Tribunal, subject to future periodic reviews of WACC parameters. This simple amendment will maintain the original intent of the Rules in respect of the determination of tax and WACC parameters for TNSPs, while providing for correction of the value for gamma.

Additionally, it is proposed that a transitional provision be included for the forthcoming South Australian revenue reset, in the event that the proposed rule change is not in place before ElectraNet is required to submit its revenue proposal.

The proposed changes to clause 6A.6.4 and the transitional provision are set out in Attachment B.

3.3 Implications of change

As explained above, the effect of the proposed change is to ensure that future revenue determinations for TNSPs will not continue to apply an erroneous value for gamma in circumstances where the Tribunal has corrected the error.

The Proposed Rule is a once-off amendment that applies prospectively and does not pre-judge or encroach upon the AER's scheduled review of rate of return and tax parameter values, which must be completed by March 2014. The effect of the proposed amendment is that the value of gamma determined by the Tribunal will be deemed to apply until the next review of rate of return parameters is concluded, at which point the AER will again review the value for gamma and may, on the basis of that review, revise the value.

ElectraNet is aware that the AER has proposed a number of changes to the NER relating to the economic regulation of electricity and gas networks. ElectraNet's Proposed Rule is entirely unrelated to and independent of the wide-ranging issues raised by the AER's proposed rule change. The matter addressed by this Proposed Rule is limited to addressing an anomaly that has arisen from the Tribunal's recent findings in relation to gamma.

4 Power of the AEMC to make the Proposed Rule

Under section 91(1) of the NEL, the AEMC may make a rule at the request of any person, the MCE or the Reliability Panel. As such, ElectraNet may request that the AEMC make or amend a rule.

The subject matter about which the AEMC may make rules is set out in section 34 of the NEL. ElectraNet considers that the Proposed Rule falls within the subject matters that the AEMC may make rules about, including the following items in Schedule 1 of the NEL: item 15, (the regulation of revenues earned or that may be earned by owners, controllers or operators of transmission systems); and item 22(c) (the determination by the AER of allowances for the income tax payable by corporations).

5. How the Proposed Rules satisfy the legislative tests

Under section 88 of the NEL, the AEMC may only make a rule if it is satisfied that the rule will or is likely to contribute to the achievement of the National Electricity Objective. Additionally, under section 88B of the NEL the AEMC must take into account the revenue and pricing principles in making a rule that relates to (inter alia) regulation of revenues earned by TNSPs.¹²

The National Electricity Objective is defined by section 7 of the NEL as follows:

The objective of this Law is 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.*

As noted above, the revenue and pricing principles state that a network service provider should be provided with a reasonable opportunity to recover at least the efficient costs of providing direct control network services and complying with regulatory obligations.

ElectraNet's proposal is to make the minimum amendment necessary to clause 6A.6.4 of the NER, in order to provide TNSPs with a reasonable opportunity to recover their efficient costs in forthcoming regulatory periods. In the absence of this amendment, TNSPs' revenue requirements will be understated in future periods in a way that is inconsistent with the revenue and pricing principles.

ElectraNet considers that the Proposed Rule change is likely to contribute to the National Electricity Objective for the following reasons:

- Correcting errors in the AER's previous determination of the value for gamma will promote efficient investment in regulated assets, by ensuring that revenue allowances for TNSPs reflect the efficient costs of providing regulated services. In the absence of this rule change, revenue allowances will be understated in future transmission determinations, creating a risk of under-investment in electricity transmission infrastructure.
- Incentives for efficient investment will be distorted in circumstances where the value of gamma is knowingly set too high for the forthcoming regulatory period, but is likely to be adjusted downward for later periods. This may create incentives for a TNSP to defer capital expenditure to a later period when the value of gamma will be corrected. The Proposed Rule will ensure that the correct value of gamma is applied at the next revenue determination and thereby provide appropriate incentives for investment, consistent with the National Electricity Objective.
- A similar issue arises in relation to the choice between transmission and distribution investment. As noted above, Chapter 6 of the NER provides for departure from findings of a WACC review where there is persuasive evidence justifying this, and therefore distribution determinations may adopt the corrected value of gamma. Allowing a different value for gamma between the electricity

¹² Section 88B applies where a rule determination relates to certain matters that are set out in Schedule 1 of the NEL. These matters include "the regulation of revenues earned or that may be earned by owners, controllers or operators of transmission systems from the provision by them of services that are the subject of a transmission determination" (NEL Schedule 1, item 15).

transmission and distribution sectors distorts the investment incentives between the two networks. Avoiding such a distortion is consistent with the National Electricity Objective.

- As the rule change promotes efficient investment it is likely to benefit customers in terms of the quality, reliability and security of supply.

6. Expected benefits and costs of the Proposed Rule

As discussed above, the proposed rule change will promote the achievement of the National Electricity Objective by avoiding outcomes that would be inconsistent with the Revenue and Pricing Principles and that would distort the incentives to invest. The benefits from the Proposed Rule will be derived from appropriate transmission prices that enable TNSPs to recover their efficient costs and by providing appropriate incentives to invest.

A further benefit from the Proposed Rule is that it makes proper use of the substantial resources committed by the Tribunal to correct the errors in the 2009 Review and in commissioning a state of the art dividend drop-off study.

ElectraNet does not expect that there will be any changes to market systems, additional compliance, procedural or other administrative costs arising from implementing this Proposed Rule.

The drafting changes are minimal and do not require any further work to be undertaken by the AER or interested parties.

In summary, ElectraNet considers that the benefits in promoting the National Electricity Objective substantially outweigh the cost associated with the impact of the Proposed Rule.

Attachment B: Proposed Rule

B.1 Amendments to clause 6A.6.4 (amendments marked in red text)

6A.6.4 Estimated cost of corporate income tax

- (a) The estimated cost of corporate income tax of a *Transmission Network Service Provider* for each *regulatory year* (**ETC_t**) must be calculated in accordance with the following formula:

$$ETC_t = (ETI_t \times r_t) (1 - \gamma)$$

where:

ETI_t is an estimate of the taxable income for that *regulatory year* that would be earned by a benchmark efficient entity as a result of the provision of *prescribed transmission services* if such an entity, rather than the *Transmission Network Service Provider*, operated the business of the *Transmission Network Service Provider*, such estimate being determined in accordance with the *post-tax revenue model*;

r_t is the expected statutory income tax rate for that *regulatory year* as determined by the *AER*; and

γ is the assumed utilisation of imputation credits, which is deemed to be 0.25.

For these purposes:

- (1) the cost of debt must be based on that of a benchmark efficient *Transmission Network Service Provider*; and
 - (2) the estimate must take into account the estimated depreciation for that *regulatory year* for *tax* purposes, for a benchmark efficient *Transmission Network Service Provider*, of assets where the value of those assets is included in the regulatory asset base for the relevant *transmission system* for that *regulatory year*.
- (b) The *AER* must, in accordance with the *transmission consultation procedures* and clause 6A.6.2(j), carry out reviews of the matters referred to in paragraph (d).
- (c) The *AER* must conclude the first review by 1 May 20~~14~~¹⁹ and conclude subsequent reviews at intervals of five years with the first interval starting from 31 March 20~~14~~¹⁹.
- (d) The *AER* may only review the value of and methodology used to calculate the assumed utilisation of imputation credits as referred to in paragraph (a) (or as subsequently revised under this clause 6A.6.4).
- (e) Where the value of the assumed utilisation of imputation credits referred to in paragraph (d) cannot be determined with certainty, the *AER* must have regard to:
- (1) the need to achieve an outcome that is consistent with the *national electricity objective*; and
 - (2) the need for persuasive evidence before adopting a value that differs from the value that has previously been adopted for it.
- (f) If, as a consequence of a review, the *AER* decides to adopt a revised value or methodology, it must use that revised value or methodology, but only for the purposes of a *Revenue Proposal* that is submitted to the *AER* under clause 6A.10.1(a) after the completion of the first review or after completion of the five yearly reviews (as the case may be).

B.2 Transitional provision for South Australia

11.# Rules consequential on the making of the National Electricity Amendment (Economic Regulation of Distribution and Transmission Services) Rule 201#

11.#.1 Definitions

For the purposes of this rule 11.#:

relevant transmission determination means the *transmission determination* for the *Transmission Network Service Providers* in South Australia for the *regulatory control period* commencing on 1 July 2013.

11.#.2 Estimated cost of corporate income tax to be applied to be applied in the South Australia transmission determination for the regulatory control period commencing on 1 July 2015

In relation to a relevant transmission determination in South Australia:

- (a) Clause 6A.6.4(f) does not apply for the purposes of a *Revenue Proposal*.
- (b) For the purposes of determining the estimated cost of corporate income tax referred to in clause 6A.6.4, the *AER* must apply a value for assumed utilisation of imputation credits of 0.25.