Promoting efficient investment – protecting consumers from paying more than necessary

AER Chairman's Address
AEMC Public Forum
23 November

Good morning and thank you John for the opportunity to present on the AER's proposed rule change.

Today, I will set out why and how the AER considers that our proposed changes are more effective in meeting the National Electricity Objectives and better support the long term interests of consumers than the existing rules.

Slide 1 - Overview

I will briefly discuss the objectives and principles set out in the law, then consider the current rules and their shortcomings before setting out the AER's proposed changes.

Slide 2 - NEO

In particular before I go through the substance of the rule change proposal before you, I will spend some time explaining how the national electricity objective relates to the revenue and pricing principles. In our view, a proper examination of the interaction between the national electricity objective and the revenue and pricing principles will demonstrate that the rule changes that we have proposed are by far preferable to the existing rules in supporting the long term interests of consumers.

The national electricity objective is:

> *"to promote efficient investment in and efficient operation of electrical services in the long term interests of consumers with respect to price, quality, safety, reliability and security of supply."*

Sitting under this objective are a set of revenue and pricing principles that are relevant to both the AEMC in its rule making capacity and ourselves as the economic regulator.

Slide 3 – NEL 7A – 2, 3, 6

Section 7A of the National Electricity Law contains 7 revenue and pricing principles that must be taken into account. Three of these principles, listed on this slide, are central to this Rule change proposal.

First, networks should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing services and complying with regulatory obligations. Explicit in this principle is that neither the AEMC or the AER can act to deny network service providers a reasonable opportunity to recover at the least the efficient costs of providing the required services. This is a critical consideration and one that has been at the heart of the development of this proposal.

Second, networks should be provided with effective incentives in order to promote economic efficiency including efficient investment in and provision and use of network services. Again, you will see from our rule change proposal that the need for effective incentives has been recognised in our proposal.

Third, there is a need to have regard to the economic costs and risks of the potential for under and over investment by a regulated network service provider. In part, this principle relates back to the first one I have listed in that it is recognised that the economic cost of under-investment in services is greater than the economic cost of a small over-investment. This asymmetry is well understood in regulatory economics and is key to the deliberations of regulators. Again, this asymmetry is something that the AER has explicitly acknowledged and addressed as part of our rule change proposal.

Slide 4 – 2006 reforms

In 2005, the AEMC was tasked with reviewing the rules governing the regulation of electricity transmission revenues. Their review led to the release of new rules in November 2006, which the MCE subsequently used as the base for the distribution rules two years later.

In the context of general concern about the adequacy of investment in infrastructure at the time, the AEMC focussed on delivering rules that not only created certainty for investment returns, but in our view, set out to minimise the potential for under-forecasting of investment needs.

The AEMC's approach to promoting investment was to prescribe key elements of the rules governing the regulation of TNSPs. Chapter 6A, and chapter 6 which followed, codified not only the procedural rules that govern the process by which regulatory decisions are made, such as decision making timeframes, but also core elements of the substantive rules. This included specifying the methodologies and decision making criteria that govern the application of regulation to individual businesses. This was significantly different to regulatory approaches in other industries and both internationally and in state based regulatory regimes.

In developing this prescriptive regulatory framework, the AEMC sought to 'improve the environment for investment by increasing regulatory clarity and certainty through the Rules.'

In our view, the current Rules go further than necessary to ensure that firms are given a reasonable opportunity to recover at least efficient costs, as required by the Revenue and Pricing Principles. We consider that the restrictions that the Rules put on the regulator mean that customers are paying more than the amount necessary to meet the principles set out in the law.

Slide 5 – expenditure change

If we look at the expenditure outcomes from these new rules, we can see that they were successful in supporting a step change in network capital and operating forecasts. The data from the first round of network determinations shows that allowances to businesses have increased dramatically in aggregate compared with previous expenditure – the AER has approved network and operating expenditure of $56 billion. To put this in context, the expenditures for the previous period were $36 billion.

We recognise that these increases are due in large measure to the need for increased investment to replace ageing assets and to meet increased peak demand, growing customer connections and higher reliability standards. The impacts vary from business to business. In addition, changes in costs of capital and in particular the costs of debt, account for further increases in revenue allowances.

However, the AER considers that these increases are likely to be greater than necessary to meet the efficient needs of the businesses. This is because the rules provide opportunities and incentives to the businesses to overestimate their required revenues while limiting the ability of the regulator to test these estimates to ensure they represent efficient costs.

Slide 6 – overview of proposals

The AER is proposing two key changes to the national electricity and gas rules. First, we propose to amend the process for estimating how much electricity network businesses need to spend in order to provide a safe and reliable electricity supply. Second, we propose reforms to the way in which the returns that electricity and gas network businesses may earn on their assets is determined.

The rule change proposal also includes improvements to the process for making decisions, making it easier for interested parties to participate in the process.

Our proposal retains the fundamentals of the current regime. It does not touch the certainty that is provided to all stakeholders from having the process of regulation codified in the rules. This was a key benefit of the change to the rules in 2006.

Our proposal also retains the notion that the price outcomes for customers should be the same, whether the network is in Government or private ownership. This means that all businesses are entitled to receive a benchmark private sector commercial rate of return. But hand in hand with this goes the notion that consumers should only pay for productivity and efficiency levels commensurate with a prudent and efficient commercial business. For this to happen, the regulator needs not only the tools to assess benchmark levels of efficiency, but also has the capacity to apply those tools.

Slide 7- objective – principles – objectives – criteria flow diagram

The structure for the regulator's decisions derives from the National Electricity Objective and the revenue and pricing principles in the law. These then feed into a set of expenditure criteria, objectives and factors that are enshrined in the rules.

The AER's proposal retains both the clear and consistent set of revenue and pricing principles in the Law and the expenditure objectives in the Rules. This means that decisions of the AER will still require networks to be afforded a reasonable opportunity to recover at least efficient cost, but removes the ambiguous inclusion of both ‘what to do’ and ‘how to do it’ procedural and substantive factors that are currently set down in the rules.

Slide 8 - expenditure

The current rules require the AER to accept expenditure proposals from businesses if we are satisfied that the business proposal reasonably reflects efficient, prudent and realistic expenditure.

The AEMC chose the expression ‘reasonably reflects’ to recognise that it is impossible to be precise in forecasting expenditure needs. There are many expenditure forecasts that would meet the ‘efficient, prudent and realistic’ criteria. The current rules allow network businesses to propose the highest possible forecast and place the evidentiary burden on the AER to prove that the proposed forecast is not efficient and not prudent. Even if there is a lower forecast that is efficient, prudent and realistic, the rules preclude the AER from adopting that lower forecast.

This problem is further compounded for electricity distribution businesses, with two further restrictions on the AER’s discretion under chapter 6. Under chapter 6, if the AER considers a proposed forecast is too high and is not satisfied it reasonably reflects the expenditure criteria, in substituting what it considers should be the efficient, prudent and realistic forecast, it can only do so by amending the proposed forecast to the minimum extent necessary for it to be approved under the rules.

Second, the AER must base its substitute on the original proposal. This forces the AER to conduct a detailed line by line assessment of the proposed forecast, rather than making an assessment based on the proposal and other supporting information to arrive at a less-biased forecast.

All solutions that meet the requirements of the National Electricity Objective and the revenue and pricing principles should be able to be considered. That is not the case under the current rules.

Slide 9 – evidence – example of problem

It is not possible to quantify the extent to which price rises have exceeded efficient levels because of the current rules framework. While the AER has only assessed proposals against the current framework, not against a hypothetical alternate set of rules , there are specific examples where the AER considers the rules have restricted us from setting a forecast consistent with the NEO and the revenue and pricing principles.

For example, in our draft decision for the Victorian distribution networks the AER applied reductions to the proposed reinforcement capital expenditure. These reductions were determined on the basis of a detailed examination of around 30 per cent of each network's proposed expenditure, which found that project costs were inflated by around 15 per cent.

However, regardless of the fact that systemic over-estimation had been found in the proposals, given the restrictions in the rules that I have outlined, it was not possible to extend these findings across all of the forecast, without examining (line by line) each of the project forecasts. This level of detailed examination of each and every project is not practical in the process set out under the rules. Had we done so, the expenditure forecasts may have been at least $200 million less than was included in the final decision..

Similarly, during the TransGrid review the AER's consultants conducted a detailed review of 32% of TransGrid's proposed planned network expenditure. The consultants identified a number of weaknesses in TransGrid's analysis which led them to recommend $77m of cuts to the relevant projects. If an equivalent level of cost savings had been applied to the remaining 68% of projects which were not considered in detail, the cuts would have come to $127.5 million.

While we can only speculate about the results of being able to apply a holistic, top down assessment, based on sound engineering and economic information and advice, we consider that it is likely that further efficiencies could have been identified, while still meeting the requirements of the revenue and pricing principles.

Slide 10 – AER proposal - expenditure

The changes being proposed by the AER would allow a more balanced approach to setting forecasts, while ensuring that networks are funded to provide a safe and reliable electricity supply.

In many respects our proposal does not fundamentally alter the conduct of a regulatory reset process, which would still begin with a revenue proposal from the business. The existing expenditure objectives remain unchanged from the current regime. The same applies to the transparent expenditure factors, which we are only recommending some minor clarification to.

Under our proposal, the AER would assess the information submitted relative to the expenditure objectives set out in the Rules using a range of different techniques. These techniques could include a mix of bottom-up assessments of the proposal, top-down benchmarking, activity based analysis, a detailed review of a sample of projects and/or an expert review of costs.

The AER would publish its draft decision, NSPs would be able to submit a revised proposal and interested parties would have the opportunity to submit comments. We would base our final decision on comments received, further analysis of the NSPs' revised proposals and any other relevant information.

All of this would be bounded by the requirements in the Law and guided by a clear, consistent and transparent list of expenditure factors set out in the rules. This would allow the AER to weigh up all available information, evidence and data in order to reach a balanced decision on forecast expenditure.

The result would be an impartial estimate of required expenditure. These proposals are not radical, but would place the regulation of the electricity sector back in line with normal regulatory practice in other countries and across other industries.

Slide 11 – efficiency

The final thing I will add on our expenditure proposal is the recommended strengthening of the capital expenditure incentive. As I outlined at the start, one of the revenue and pricing principles requires that networks be provided with effective incentives in order to promote economic efficiency.

The evidence to date is that some consumers have been subjected to significant price shocks as a result of the rolling into the asset base of previous expenditure above forecast levels. Currently, the value of all capital expenditure is automatically rolled into the asset base, without ex-post review of efficiency, regardless of whether the total expenditure has exceeded the ex-ante forecast.

In some circumstances, the current rules create incentives for networks to over-invest, even if such investment is inefficient. Consistent with the revenue and pricing principles, the AER proposes to increase the incentive on electricity businesses to invest efficiently to ensure a safe and reliable supply.

Under our proposal only capital expenditure within the approved forecast would be automatically added to the asset base. If a network spends more than was forecast, it would only be allowed to add 60 per cent of the value to the asset base. The cost of the remaining 40 per cent would be borne by the owners of the network. This greatly strengthens the discipline on the networks to properly manage their capital expenditure.

Slide 12 – uncertainty

I have said from the outset that both the need to balance the NEO and afford networks an opportunity to recover at least efficient cost has been central to the development of our rule change. Accordingly, the AER has developed a balanced package of measures that allow for an impartial setting of expenditure forecasts, together with increased incentives to focus on the efficiency of that expenditure.

We recognise that as part of this there needs to be mechanisms to allow networks to adjust their expenditure in the event of significant unforeseen circumstances. Accordingly, the AER also proposes additional measures for managing uncertainty, by introducing new mechanisms which permit electricity distribution networks to re-open their forecasts if a significant unforeseen event occurs. It is also proposed that the ‘contingent project’ framework currently available to transmission networks also be introduced for distribution.

This approach ensures that network businesses are able to recover at least the efficient costs of their operation, while advancing the long term interests of electricity consumers by removing the systemic upward bias in forecasts.

Slide 13 - WACC

Turning now to the setting of the weighted average cost of capital.

The AER currently administers three separate regimes for setting WACC across electricity distribution and transmission and gas.

In electricity transmission, the AER must review the WACC every five years and the results of this review must apply in each transmission determination. In electricity distribution the parameters determined during the WACC review form the starting point for consideration during the revenue determination process. These parameters can be departed from in the face of persuasive evidence of the need for a change.

The persuasive evidence test was included for electricity distribution to allow some flexibility in bringing all the jurisdictions into the one regime, recognising the different starting point for all the businesses. However, in practice the persuasive evidence test has led to a reconsideration of parameters during each revenue reset process. For example, the market risk premium and gamma have both been contested. These two parameters are subject to uncertainty and conflicting evidence and are also slow to change over time. These are precisely the type of parameters which the AEMC wanted to ensure were not open to debate at each reset when locking in the WACC review in chapter 6A, as they are fertile ground for repetitious argument in search of what is likely to be spurious levels of accuracy.

In gas, there is currently no provision for a periodic WACC review and both the parameters and indeed the financial model itself must be determined for each business at each reset.

The AER believes that all energy networks should be treated consistently.

Under our proposed approach the AER would undertake WACC reviews at intervals of no more than five years, and the outcomes of each review would apply to each subsequent energy network revenue determination.

The AER would be required to have regard to previously adopted values in tandem with all other relevant legal requirements. The WACC review would cover a range of parameters used to calculate the WACC, including the methodology for setting the debt risk premium. Currently, the AER must attempt to calculate an allowance for debt using benchmarks that are not reflective of how the sector is actually managing its debt, resulting in significantly higher prices for consumers and excessive litigation with network businesses.

What we have found is that attempting to lock any particular benchmark into the rules runs the risk that over time the benchmark loses touch with the actual debt financing practices of the sector. It is for this reason that the AER has proposed a mechanism that would allow for a holistic consideration of all parameters and the underlying methodology for their calculation as part of the WACC review, rather than attempting to codify this in the rules.

It is important to note that many of the WACC parameters are inter-linked. This lends further support to the importance of considering all of the parameters together in one review.

The AER believes that this model appropriately balances the need for the regulatory regime to keep pace with the developments in financing practices, while still providing the certainty for investors when planning and executing investment programs.

Slide 14 - Improving the regulatory process

In finishing, I will briefly outline important changes that we are proposing to ensure that all stakeholders have the opportunity to comment on substantive information as part of a revenue determination process.

The AER has proposed changes to the rules to discourage network businesses from strategically withholding key information until the final stages of the review process and from seeking confidential treatment for information which is not genuinely confidential.

Currently, electricity networks can submit submissions on their own revenue proposals. These submissions are due at the same time as submissions from other stakeholders. Often the networks' submissions contain substantial detail that should have been contained in either the initial or revised regulatory proposal. This denies stakeholders the opportunity to consider and respond to this information and compresses the time for the AER to analyse the information.

The AER proposes that networks be precluded from making submissions on their own proposals. This will ensure that all stakeholders will have the opportunity to contribute meaningfully to the revenue determination process.

While the focus of the debate has been on the expenditure and WACC sections, I consider that our recommendations to improve the process of regulation are very important and would significantly benefit all stakeholders.

Slide 15 – Wrap-up

Taken as a whole, our proposed changes are aimed at giving better effect to the national energy objective. The revenue and pricing principles, set out in the law, are sufficient for this purpose. They do not need to be expanded by provisions in the rules which tip the balance towards excessive forecasts and customers paying more than necessary. Nothing in our proposal is radical or outside of what is already considered best practice economic regulation in other sectors and in other jurisdictions.

The AER is confident that the changes that we have proposed will not only protect the incentives for efficient investment, but will also better promote the long term interest of energy users. Again, I thank you for the opportunity to present these important issues to you today.