On Thursday 29 September 2011, the Australian Energy Regulator (AER) submitted a rule change proposal to the Australian Energy Market Commission (AEMC) to protect consumers from paying more than necessary for a safe and reliable energy supply.

Policy context

The National Electricity Law (Law) lays the foundation for the regulatory framework governing electricity networks. In particular, the Law sets out the National Electricity Objective: to promote efficient investment in and efficient operation of electrical services in the long term interest of consumers. Further, the Law includes the principle that electricity network service providers should be given a reasonable opportunity to recover at least efficient costs.

However, during the development of rules for electricity transmission networks in 2006, the AEMC considered that the general protections afforded by the Law and the administrative law for regulatory decision-making were not sufficient to guard against the risk of the regulator restricting allowances to levels below efficient cost. Despite submissions at the time challenging this assumption, rules were drafted to lock down the regulatory decision making process to address the perceived risk.

This detailed codification of the methodology of economic regulation has hindered the AER's ability to appropriately regulate natural monopoly electricity networks. It has restricted the AER's ability to ensure that the regulated electricity networks invest efficiently and earn appropriate commercial returns. It has also hindered the AER's capacity to respond to changing circumstances. As a result, consumers are paying more than is necessary to maintain a reliable and secure power system.

Key changes proposed

The AER is proposing two key changes to the national electricity and gas rules to:

- amend the process for estimating how much electricity network businesses need to spend in order to provide a safe and reliable electricity supply (no equivalent change is proposed for gas)

- reform 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.

Setting expenditure forecasts for electricity businesses

The current rules require the AER to accept expenditure proposals from businesses if it is satisfied they ‘reasonably reflect’ efficient, prudent and realistic expenditure. The expression ‘reasonably reflects’ recognises that there may be more than one expenditure forecast that is efficient, prudent and realistic. Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leaves the evidentiary burden on the AER to first prove that the proposed forecast is not efficient and not prudent. Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operate to exclude the AER from setting that lower forecast.

This problem is further compounded for electricity distribution businesses due to 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. Secondly, the AER must base its substitute on the original proposal. This restricts the AER to conducting a detailed line by line assessment of the proposed forecast, rather than making a balanced assessment of all available information.

In an unbiased regime, all answers that meet the requirements of the Law could be determined. That is not the case under the current rules.

The experience from the last five years has exemplified the restrictions on the AER’s regulatory discretion and in turn suggests that concerns about inflated forecasts were well founded. While it is difficult to quantify the extent to which price rises have exceeded efficient levels, inflated forecasts have been a factor in the price rises faced by consumers.

What the AER is proposing – determining forecasts of expenditure

The AER recognises the long term risks to reliability that could arise from under-estimates of required expenditure. Indeed the Law requires the AER to ensure that electricity network businesses have a reasonable opportunity to recover *at least* efficient costs. However, the current rules go much further than this. The changes being proposed by the AER use a more balanced approach to setting forecasts, while ensuring that networks are funded to provide a safe and reliable electricity supply.

Under the proposed changes to the rules, the AER would determine the forecast of required expenditure, 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—including benchmarking analysis—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.

Ensuring investment is efficient

Currently the value of all investment (capital expenditure) undertaken by the electricity networks is added to their 'regulatory asset base.' The networks then earn a rate of return on this asset base. This occurs even if the cost of this capital expenditure is in excess of the forecast expenditure determined at the start of the period. In certain circumstances, the current rules create incentives for networks to over-invest, even if such investment is inefficient. The AER proposes to increase the incentive on electricity businesses to invest efficiently to ensure a safe and reliable supply.

The AER proposes to amend the rules so that 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.

Dealing with uncertainty

The current rules address the risk that the regulator may incorrectly set forecast expenditure by tightly prescribing the regulator's decision making functions, but this may lead to consumers paying for systemically inflated forecasts. However, the AER recognises that 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.

Setting the rate of return on the asset base

The AER also proposes to change the process for determining the rate of return that energy networks earn on their asset bases, known as the weighted average cost of capital (WACC). Unlike the rest of the rule change proposal, the AER's proposed changes to the WACC methodology apply to gas pipelines as well as electricity networks.

At present, the AER must use a different methodology to determine the WACC depending on whether the relevant network is an electricity transmission network, an electricity distribution network or a gas pipeline. 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 and gas, each network business has the opportunity to seek a unique outcome. The AER believes that all energy networks should be treated consistently.

Under this 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 WACC review would cover a range of parameters used to calculate the WACC, including the methodology for setting the debt risk premium.

The AER would be required to have regard to previously adopted values in tandem with all other relevant legal requirements. Importantly, removing some of the prescription of how a number of elements of the WACC are to be determined will ensure that the regulatory framework keeps pace with the actual debt financing practices of the sector. 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.

These changes would deliver significant improvements in process and would provide a better balance between flexibility and certainty in this aspect of economic regulation.

Improving the regulatory process

The AER's proposal would improve the efficiency and effectiveness of the regulatory process by addressing procedural problems that have arisen during the course of its reviews. In particular, the AER considers that changes to the rules are necessary 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.

Expected timeframe and next steps

The AER has submitted its proposals to the AEMC for consideration. To make the changes, the AEMC needs to be sure that the proposed changes meet the National Electricity Objective. The AER is confident that the proposed changes will maintain incentives for efficient investment and operations of the networks and advance the long term interests of consumers.

The AEMC will then follow the mandated consultation process set out in the national electricity and gas rules. The AER intends that the rules changes would be in place in time for the next round of revenue determinations in NSW and the ACT, with the first determinations under the new rules to take effect from 1 July 2014.