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10 April 2015

Ms Christine McDonald
Secretary
Senate Standing Committee on Environment and Communications
References Committee
Inquiry into Electricity Network Companies
Parliament House
CANBERRA ACT 2600

Dear Ms McDonald

RE: Senate Environment and Communications References Committee - Electricity network companies inquiry – Questions on Notice

Please find attached responses to the Questions on Notice from Senator Urquhart.

Yours sincerely

Paula W. Conboy
Chair

AER response to Questions on Notice from Senator Urquhart

1. Can the AER amend a determination if it subsequently becomes aware that it was provided with false, misleading or deceptive information by the network service provider?

Yes. Under Chapters 6 and 6A of the National Electricity Rules the AER can revoke a determination during a regulatory control period if it appears to the AER that 'false or materially misleading information' has been provided to the AER.

2. Can the AER remove assets from the regulatory asset base where the AER considers the network service provider was not efficiently minimising costs when it developed, constructed or acquired the network assets?

Under Chapters 6 and 6A of the National Electricity Rules, the AER may preclude inefficiently incurred capital expenditure from being included in the regulatory asset base, but only in circumstances where the network business's actual capital expenditure exceeds the capital expenditure allowance. These provisions were added to the rules as part of the 2012 amendments and they apply only on a prospective basis, that is for capital expenditures made by networks in respect of regulatory periods commencing after the amendments took effect.

3. Can the AER disallow any past capital expenditure it determines was inefficient, or only amounts that exceeded the capital expenditure allowance during a regulatory control period?

The AER can disallow past capital expenditure in circumstances where the network business's actual capital expenditure exceeds the capital expenditure allowance. As noted this provision applies in regulatory periods commencing after 2012.

4. The WA Economic Regulation Authority told the committee that in addition to reducing the forecast expenditure proposed by Western Power by $700 million, it excluded more than $200 million of capital expenditure already incurred from Western Power's regulatory asset base on the basis that it did not meet efficiency requirements. Does the AER have the ability to do this? Has the AER ever disallowed capital expenditure that has already been incurred?

The AER has regularly reduced the forecast expenditure proposed by network businesses.

The National Electricity Rules now provide the AER with the ability to exclude past capital expenditure from a business's regulatory asset base in circumstances where the capital expenditure is inefficient and the network business's actual capital expenditure exceeds the capital expenditure allowance. This results from the recent rule changes and applies to the next regulatory periods, so to date the AER has not been permitted under the National Electricity Rules to disallow capital expenditure that has already been incurred.

5. a. Is a regulatory control period of five years a common feature in other jurisdictions?

AER and ACCC staff recently undertook a review of regulatory practices in various countries.[1] This work suggests that a regulatory control period of five years is a common feature in other jurisdictions. Some jurisdictions are moving to longer regulatory periods. The British regulator Ofgem has recently moved to an eight year regulatory period.

[1] This review is available at https://www.accc.gov.au/system/files/Regulatory%20practices%20in%20other%20countries%20-%20Benchmarking%20opex%20and%20capex%20in%20energy%20networks.pdf

5. b. Is the AER required to make five-year determinations, or can it make determinations that cover a different period of time?

The National Electricity Rules specify that a regulatory control period must be not less than five years. Regulatory control periods have generally been five years. A network business can propose a longer period than five years to the AER. On some occasions, the AER has approved longer regulatory periods, particularly for 'single asset networks' such as the Murraylink and Directlink interconnectors.

c. If the AER cannot change the five-year period, would having the flexibility to determine the length of time the AER considers is most appropriate lead to better regulatory outcomes? For example, at times where there is upheaval and unpredictability in financial markets, like the global financial crisis, should a determination be made for five years?

The regulatory regime tries to incorporate flexibility to accommodate significant shocks that could not be foreseen at the commencement of the regulatory period. For example, the Electricity Rules provide for revenue cap re-openers, pass throughs and a contingent projects regime to deal with uncertainty. The allowed rate of return is also updated annually to incorporate annual updating of the allowed return on debt.

The additional flexibility that would be provided by having a shorter regulatory period would need to be weighed up against the associated additional cost, unpredictability for investors and impact on incentives. Under the rules, while the AER can approve a longer period, it cannot approve a shorter period. Those businesses seeking a shorter period would need to apply for a rule change to the AEMC who would be expected to take these matters into account.

6. Do electricity network businesses ever make a loss? Does the regulatory system prevent this from occurring?

The AER's role is to set a regulatory allowance for a network business, based on the costs that an efficient firm requires to provide network services. This is the amount the business can recover from its customers. A network business that is inefficient could spend more than the allowance set by the AER and make a loss as the additional amount cannot be recovered through increased prices to its customers.

7. How does the level of risk associated with a network company compare to the level of risk other businesses face? Are network businesses actually at risk of failure or a new entrant competing and taking away their customers? If not, how does the regulatory framework account for this?

Network businesses are generally considered to be relatively low risk businesses compared to the market as a whole. Network businesses generally have the obligation to distribute electricity to customers within the geographical area in which they operate, meaning that a new entrant cannot generally compete for these customers. Our current regulatory framework has in it an approach for setting the cost of capital that takes into account this lower risk profile of network businesses.

8. The Energy Users Association of Australia (EUAA) submitted that prior to 2006 the value of the networks' regulatory asset bases was 'optimised' to reflect the minimum value of assets needed to deliver the required services. Since 2006, network asset values have been determined by the Depreciated Optimized Replacement Cost (DORC) valuation approach.
a. Why was this change made?
b. The EUAA argued that businesses operating in competitive sectors predominantly use the Depreciated Actual Cost (DAC) valuation approach, which results in significantly lower asset valuations. Why is DORC used for electricity network companies rather than DAC? Do you agree with the EUAA's assessment that companies in other sectors use the DAC approach?
c. The EUAA has advocated for a rule change that would restore the asset optimisation approach. What are some of the arguments for and against such a proposal?

A number of the claims in this question are not correct. Chapters 6 and 6A of the National Electricity Rules 'lock in' the initial regulatory asset base for each of the network businesses and codify the methodology for rolling forward the regulatory asset base from one regulatory period to the next. We understand that initial regulatory asset base valuations, determined prior to 2006 by jurisdictions or jurisdictional regulators, were generally based on a DORC approach. The methodology for rolling forward the regulatory asset base involves rolling capital expenditure into the regulatory asset base at actual cost and not on a DORC basis.

The National Electricity Rules therefore do not specify a DORC approach to setting the regulatory asset base and the AER has never conducted a DORC valuation for an electricity network business.

9. The Committee has heard that the National Electricity Rules (Rules) require that the regulatory asset base is indexed to adjust for inflation.
a. What is the rationale for this rule?
b. Do the Rules mean that old assets are being valued as if they are brand new? Does the value of an asset increase every year, right up to the point where it needs to be replaced?
c. Is this approach used for electricity network regulation in other countries?
d. How does this aspect of the Rules compare to the commercial realities that companies operating in other sectors of the economy face? Do companies operating in other sectors of the economy value their assets in this way? If not, what is different about are electricity network companies that explains this divergence?

The National Electricity Rules require that the regulatory asset base is indexed to adjust for inflation. Indexation maintains the asset value in real terms. If the asset base was not indexed then the rate of return would need to be adjusted to account for this inflation risk.

Old assets are not being valued as if they are brand new. The regulatory asset base is adjusted for depreciation of the assets. Assets are depreciated until the end of their economic lives.

10. Professor David Johnstone argued that many of the easements included in regulatory asset bases were acquired by governments decades earlier ('at little cost in today's terms, and long "paid for"') and yet they appear in the asset base as if they must be re acquired today. Is this correct? What is the rationale behind this?

We understand that initial regulatory asset base valuations included an allowance for the valuation of easements. However, these easements do not appear in regulatory asset bases as if they must be re-acquired today.

11. What action did the AER take in response to claims made in the media in September 2014 by Cally Wilson, a former employee of Energex, that Energex manipulated data to drive up power prices?

The AER has raised Ms. Wilson's claims with Energex. The information received by the AER through these discussions will be taken into account, and reflected in, our preliminary determination to be released on 30 April.

More generally, our analysis in examining the proposals is aimed at ensuring that data is robust and resulting costs are efficient such that consumers are paying no more than necessary for safe and reliable electricity services

12. If Energex submitted an inflated claim, would the AER pick it up? Would inflated claims submitted by a company matter, or does the AER's benchmarking process reveal unrealistic claims? Are there areas that are unique to particular businesses where inflated claims would be more problematic, such as operating expenditure?

As highlighted in our submission to this Inquiry[2], recent changes to the regulatory framework provide the AER with the ability to deal with inflated claims by business, be they in relation to rate of return or expenditure forecasts.

13. How does the AER assess operating expenditure? Does the AER consider actual operating expenditure when forecasting future operating expenditure?

The AER approves an allowance for operating expenditure prior to the start of each regulatory period.

Our general approach[3] is to assess the efficiency of a network business and determine whether previous operating expenditure spending is an appropriate starting point. If a business has been responding to incentives to improve its efficiency, its past operating expenditure is often a good indicator of how much it will need to spend in future. If the business is not responding to incentives, we will set forecasts with reference to benchmarks of more efficient firms that reflect efficient costs such that consumers are paying no more than necessary for safe and reliable electricity services.

To assess a business's proposed expenditure, we apply a range of techniques that typically involve comparing the proposal to estimates we develop from relevant information sources. Where these techniques indicate the expenditures are not efficient, we will set our own efficient forecast. The techniques include:

- economic benchmarking—productivity measures used to assess a business efficiency overall

- category level analysis—a key benchmarking tool, comparing how well a business delivers services for a range of individual activities and functions, including over time and with its peers

- trend analysis—forecasting future operating expenditure based on historical information (much operating expenditure spending is recurrent and predictable).

14. In her submission to the AER on Energex's 2015–2020 regulatory proposal, Cally Wilson claimed that Energex was overstaffed, that Energex employees receive overly generous employment conditions, and that Energex employees can only be made voluntarily redundant.

a. How does Energex's operating expenditure compare to other businesses the AER regulates?

The AER's November 2014 report *Electricity distribution network service providers - annual benchmarking report* includes a range of comparisons of the operating expenditure of all electricity distribution businesses in the NEM.[4]

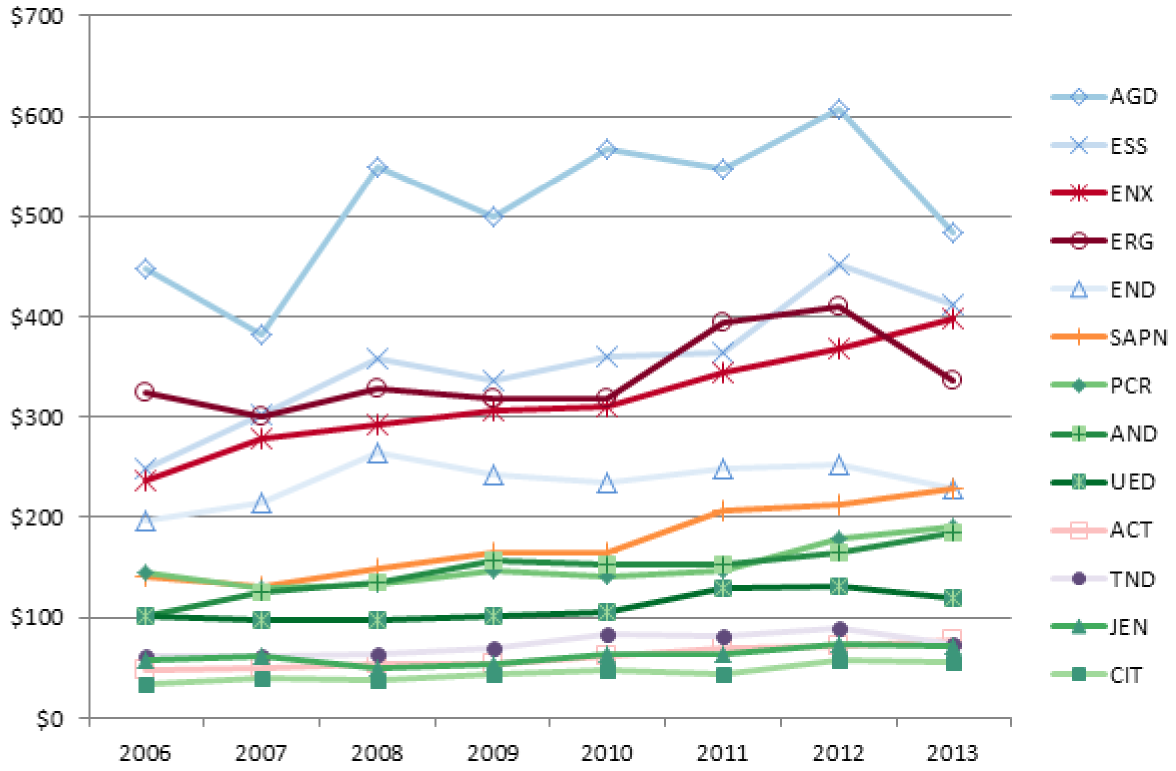
Figure 20 of this report presents total operating expenditure over the 2006–13 period. It illustrates that there is considerable difference in operating expenditure for each of the distribution businesses with Ausgrid spending the most, approximately $484 million in 2013 and CitiPower spending the least, approximately $55 million in the same year. Energex had the third highest operating expenditure of the distribution businesses in 2013.

[2] http://www.aer.gov.au/sites/default/files/Senate%20Inquiry%20into%20electricity%20network%20companies%20-%2018%20December%202014.pdf

[3] More detail on the AER's operating expenditure assessment approach is available in the overview of the AER's Better Regulation program available at http://www.aer.gov.au/sites/default/files/AER%20Overview%20of%20the%20Better%20Regulation%20reform%20package.pdf

[4] The report is available at http://www.aer.gov.au/sites/default/files/2014%20Annual%20distribution%20benchmarking%20report%20-%20November%202014_0_0.pdf

Opex by distributor ($ millions, 2013)



b. Has the AER discussed these allegations with Energex?

Yes. The information received by the AER through these discussions will be taken into account, and reflected in, our preliminary determination to be released on 30 April.

c. Has the AER ever significantly reduced a company's proposed operating expenditure allowance?

In January 2014, in the latest final decision released by the AER, we determined an operating expenditure allowance of $560 million for the Victorian transmission network operator, SP AusNet. The business had proposed an allowance of $600 million.

In November last year, the AER released draft decisions for eight network businesses. These are the first proposals to be considered after changes to the National Electricity Rules. These draft decisions propose significant reductions on the operating expenditure proposals of the electricity distribution businesses in New South Wales and the ACT of between 22% and 42% on the businesses' proposals.

We note that these AER draft decisions were based on information before us at the time. The businesses have subsequently submitted revised proposal. The AER is considering these revised proposals and will release final decisions later in April.

15. The Australian Financial Review reported comments by Ms Conboy that the state power companies were bloated and could cut costs easily by meeting private sector benchmarks. Are consumers in NSW and Queensland paying more for electricity than necessary because the state-owned businesses have excessive operating costs?

The Australian Financial Review article provides the journalist's commentary on the interview with Ms. Conboy. The AER Chair was not quoted in the article.

Ms Conboy was highlighting the work that the AER had undertaken benchmarking the performance of network businesses across the NEM. This benchmarking work indicates that the network businesses in Victoria and South Australia are more efficient than the businesses in New South Wales and Queensland.

16. Some submitters called for the actual cost of debt to be used in WACC calculations instead of using the cost of debt of a benchmark company. What would be the potential advantages and disadvantages of using the actual cost of debt in the WACC, perhaps capped at an amount determined by the AER?

Using the cost of debt of a benchmark company creates an incentive for networks to finance themselves efficiently and "beat" the benchmark. It also means consumers are shielded from inefficient costs if a network's costs are higher than the benchmark. Conversely, using a network's actual cost of debt would mean a network would no longer have an incentive to finance itself efficiently, and consumers would wear the consequences of inefficient costs.

17. Mr Bruce Mountain argued that the AER's benchmarking model uses 'a very standard tax calculation' given that private companies engage in tax minimisation strategies. Mr Mountain claimed that SA Power Networks 'were allowed $414 million in the regulatory period just ended', and in the first three published accounts he found they had a credit of $4.2 million.
a. How is tax accounted for when determining the amount of revenue a privately-owned network company can recover from its consumers?
b. Does the AER look at actual tax expenditure? If not, why not?
c.It was reported in The Australian that owners the of Victoria and South Australia's privatised electricity networks have forfeited $1.1 billion in tax losses as part of ongoing disputes with the ATO over profit-shifting and tax minimisation. It was claimed that loans from their overseas owners were used to offset tax in Australia.
i. If such schemes operated, what are the implications of this for the assumptions made in AER determinations about tax?
ii. Could profit-shifting and tax minimisation strategies mean that network companies are recovering tax that was not paid from electricity consumers?
iii. Has the AER discussed tax minimisation strategies that electricity networks may use with the ATO?

The 'building block' model includes an allowance for the estimated cost of corporate income tax. The National Electricity Rules require that the estimate should be based on a benchmark efficient business and not reflect a business's actual tax arrangements. The benchmark is based on the prevailing corporate tax rate. This provision has been in the National Electricity Rules since their inception.

We cannot comment on matters within the ATO's responsibilities. The AER has not discussed these matters with the ATO.

18. How many pages of documents do distribution network companies submit as part of a regulatory proposal? For example, how many pages has Energex submitted?

The AER is due to release decisions for eight network businesses (covering electricity distribution and transmission, and gas distribution) in April 2015. Table 1 highlights the number of pages in submissions to support the regulatory proposal and revised regulatory proposals for these businesses.

Table 1 - Number of pages in submissions to support regulatory proposals and revised regulatory proposals

	Regulatory proposal - total number of pages in submission	Revised regulatory proposal - total number of pages in submission
Transgrid (NSW, ACT electricity transmission), 2014-19	35,033	1,161
Ausgrid (NSW electricity distribution),2014-19	22,600	5,504
Essential Energy (NSW electricity distribution), 2014-19	15,209	9,907
Endeavour Energy (ACT electricity distribution), 2014-19	6,580	8,501
Actew AGL (ACT electricity distribution), 2014-19	N/A	12,183
TasNetworks (Tas electricity transmission), 2014-19	4,700 (approx)	9
Directlink (NSW-Qld electricity interconnector), 2015-20	3,368	N/A
Jemena Gas Networks (NSW gas distribution), 2015-20	7,071	N/A

The AER is due to release draft decisions for three electricity distribution businesses on 30 April 2015. Table 2 highlights the number of pages in submissions to support the regulatory proposals for these businesses. Energex's submission (including attachments) is 2,697 pages.

Table 2 - Number of pages in submissions to support regulatory proposals

	Regulatory proposal - total number of pages in submission
Energex (Qld electricity distribution), 2015-20	2,697
Ergon (Qld electricity distribution), 2015-20	8,549
SA Power Networks (SA electricity distribution), 2015-20	16,807

19. Do you consider energy network companies only provide what is strictly necessary, or are there incentives to try to overwhelm the regulator with documentation? Is the AER resourced to deal with voluminous proposals?

The regulatory framework allows the businesses to submit the material they consider necessary to support their regulatory proposals.

The framework also allows the AER to require the businesses to provide the information we consider necessary - as part of the regulatory proposal, and part of ongoing performance monitoring and benchmarking. We have collected data that allows us not only to determine how an individual business is tracking over time, but also allows us to compare the businesses with each other. This has enabled us to focus our inquiries on the areas within the businesses that really matter.

The AER is resourced to undertake its network regulation roles. These resources have enabled us to recruit and retain experienced staff, build up in house technical engineering capability, and have access to internationally respected independent consultants. That said, the AER's operating environment is challenging at the moment. We are in the midst of an unprecedented workload, with regulatory resets underway for businesses in NSW, Tasmania, the ACT, South Australia and Queensland, and about to commence in Victoria. In this environment, we are very aware of the challenges that are posed by having to deal with regulatory proposals and submissions of the length noted in our response to Question 18.

20. Does the AER have any insight into the amount of money network companies spend on the determination process?

The costs of preparing a regulatory proposal forms part of a business's operating expenditure, but we do not specifically request information on reset costs from network businesses. Therefore, we are not fully aware of the costs that are associated with the determination process across all businesses.

However, preparing a regulatory proposal, and engaging consultants and experts to assist in the preparation of a regulatory proposal, is clearly a resource intensive process for the network businesses.

21. Would a template or some form of limit on the number of documents be beneficial for the AER, as well as for other interested parties that try to review regulatory proposals?

The National Electricity Rules and our Better Regulation guidelines specify the form in which some classes of material must be presented by the network businesses to the AER. That said, dealing with the volume of material associated with regulatory proposals is resource intensive for the AER and other stakeholders. It is worth considering changes to the framework that could make the regulatory process more effective.

There have been significant efforts to better engage consumers in network regulatory decision making. In some instances the volume of material lodged in regulatory processes could detract from these efforts. However we are still seeing greater involvement from a wider variety of interested parties in our consultation processes. The changes to the National Electricity Rules requiring publication of 'user friendly' material may be important in this regard.

22. Do the Rules limit the amount of expenditure related to the preparation of a regulatory proposal that network businesses can recover from their customers? If not, does the AER consider this is a proposal that should be considered further?

The costs of preparing a regulatory proposal forms part of a business's operating expenditure. The AER determines the business's overall operating expenditure allowance that businesses are ultimately allowed to recover from consumers, but we do not set an explicit allowance for preparing a regulatory proposal. The overall operating expenditure is set based on efficient costs and it is not clear what additional benefit would be gained through setting a limit on regulatory proposal costs.

23. How frequently are determinations appealed to the Australian Competition Tribunal? For all of the determinations that are currently in place, how many were appealed to the Tribunal after the AER made them? How many determinations were changed by the Tribunal?

From 2008 to 2013, network businesses sought review of 18 AER determinations on electricity networks—three reviews in transmission and 15 in distribution. The Tribunal's decisions increased allowable electricity network revenues by around $3.2 billion. The two most significant contributors to this increase were Tribunal decisions on:

- the averaging period for the risk–free rate (an input into the weighted average cost of capital)—reviewed for five networks, with a combined revenue impact of $2 billion

- the value adopted for tax imputation credits (gamma), which affects the estimated cost of corporate income tax—reviewed for eight networks, with a combined revenue impact of over $900 million.

In November 2013, these merits review arrangements were amended. Key features of the new merits review framework were outlined in the AER's submission to this Inquiry.[5] These changes introduce a new threshold for an affected party to seek merits review. First, they must identify an error in one of our determination decisions. Second, they must establish that correcting that error will result in a decision that overall is materially preferable outcome in the long-term interests of consumers. To date, no businesses have applied for review of an AER decision under this new framework.

24. In his submission, Mr Bruce Mountain wrote that:
In 2011, the two Queensland distributors successfully appealed against the AER's decision on dividend imputation in the calculation of income tax allowances. Their argument was based on the imputation of dividends paid by privately owned companies and ignored the fact that these distributors' profits are effectively untaxed (because the Queensland Government collects the income tax).

According to Mr Mountain, following the appeal the distributors could have recovered an extra $400 million from their consumers, however, the Queensland Government instructed them not to do so.

a. How much did the AER spend defending its original decision?

The AER's costs in this matter exceeded $1.2 million. This figure does not include the costs of AER staff members or in-house lawyers.

b. When considering tax allowances, does the AER make any distinction between the tax obligations of private companies and state-government owned companies?

As highlighted in the answer to Question 17, the National Electricity Rules require that the allowance for the estimated cost of corporate income tax be based on a benchmark efficient business. Therefore, for the purposes of setting this allowance no distinction is made between private companies and state-government owned companies.

25. The Central Irrigation Trust told the committee that because they are located near the interconnector between South Australia and Victoria, when a South Australian generator sells power to Victoria, they pay for the transmissions losses.

a. Is the AER able to explain the rationale behind this?

The Australian Energy Market Operator (AEMO) applies a methodology that was developed by the industry after extensive consultation to calculate transmission loss factors.

b. Why do consumers in the state that generates power sold to another state pay for the transmission losses?

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[5] http://www.aer.gov.au/sites/default/files/Senate%20Inquiry%20into%20electricity%20network%20companies%20-%2018%20December%202014.pdf

This is not true in general. The rules are designed to ensure that consumers in the importing region pay for losses (i.e. the customers who consume the energy should pay for losses in its transport). This principle is embodied in the calculation methodology AEMO uses. However, the outcome for the Central Irrigation Trust appears to differ from the principle. This is not a matter, however, that can be addressed directly by the AER and the application of the methodology may need to be reviewed by AEMO.

c. Would it be more equitable if the cost associated with these losses were spread across all users in the state?

While there may be some anomalies with the way the methodology is applied to Central Irrigation Trust, we need to also be mindful of the impact of approaches that spread the costs over all users. The NEM relies on transmission marginal loss factors to create a price signal about the best location to site a major load. If this signal is smeared it will lead to inefficient future investment by new major loads and cause existing customers to subsidise new industries.

26. Do generators pay any network costs? If not, what is the reasoning behind this? Is this approach common, or is it unique to Australia's framework (for example, do generators pay network costs in Great Britain)?

No charges are imposed on generators for using the shared transmission network. Issues around 'who pays' for the shared network have been canvassed in a range of reviews since market commencement. The AEMC's Optional Firm Access Review has highlighted that since 1997 there have been no fewer than eleven major reports and reviews dealing with various aspects of congestion management and generator access to the transmission network. The AEMC's work provides a comprehensive discussion of the findings of these previous reviews.[6]

The approach of generators not paying for using the shared transmission network is not unique to Australia. In Ontario, for example, generators do not pay for transmission.

27. How is the AER funded? Are energy regulators in other countries funded under a similar model? Are there examples of energy regulators funded by other means, such as a cost recovery model, in any comparable countries?

The AER is funded by the Commonwealth, through the ACCC’s agency appropriation, but through a separate programme.

While many regulators are similarly funded through agency appropriations, in some jurisdictions (such as New Zealand) the government is reimbursed for the cost of funding the regulator through a levy on industry participants or by imposing licence fees.

The Ontario Energy Board and intervenors of record are industry funded. Under this approach, when the work load increases, the funding increases as well.

[6] http://www.aemc.gov.au/Markets-Reviews-Advice/Optional-Firm-Access,-Design-and-Testing