

17 March 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 Singh.

Yours sincerely

Michelle Groves
Chief Executive Officer

AER response to Questions on Notice from Senator Singh

- 1. The share prices of regulated network service providers have increased significantly since your guidelines have been completed and the West Australian newspaper carried a story recently that Western Power is keen to be regulated by the AER rather than the West Australian regulator, who sets a much lower cost of capital than the AER. Does this suggest that network owners are pleased with the guidelines, despite what their managers say?*

We are not in a position to comment on network owners' level of satisfaction with the rate of return guidelines. We can however provide some advice on how a number of the network businesses have responded to the approach outlined in the rate of return guideline.

In the network determination processes we are currently finalising, network businesses (with the exception of TasNetworks) have proposed departures from our rate of return guideline. These departures include proposals to depart from the BBB+ credit rating and transition to the trailing average for calculating cost of debt, and our approach to estimating the return on equity. These proposed departures would lead to higher cost of capital estimates compared to those associated with our guidelines.

We are not able to comment on the precise drivers of share price movements. However, we do have access to some information that may be of assistance.

As you highlight, the share prices of listed infrastructure providers, DUET, SPARK, AusNet Services and APA, have risen since the guidelines were released in December 2013. The market as a whole has risen since this time, although not to the same level as some of the listed infrastructure providers.

One of the factors which could explain why the share prices of listed infrastructure providers have outstripped the market as a whole since late 2013 concerns trends in bond yields. It is generally recognised that regulated infrastructure providers' share prices have some correlation with bond yields. The Commonwealth Government Securities bond yields have come down since around the time the AER released its rate of return guideline. Worldwide, yields on long term bonds are lower with some developed country bonds trading at a negative yield. In this low government bond yield environment, the search for better yields could explain some of the movements in share prices of listed infrastructure providers.

- 2. Can the AER demonstrate how the current and unorthodox separation of rule-making by the Australian Energy Market Commission (AEMC) and rule implementation by the AER is in the long-term interests of consumers?*

Energy market governance is a policy consideration determined by CoAG.

The governance arrangements whereby high level energy policy is developed by the CoAG Energy Council (formerly the Ministerial Council on Energy), rule making is undertaken by the AEMC and rule implementation is undertaken by the AER was developed by CoAG and came into operation from 2005.

At the time this framework was being developed, the Ministerial Council on Energy argued 'this new framework will improve accountability, streamline decision-making and remove

unnecessary duplication of regulatory processes. It is designed to provide an appropriate balance between development and implementation of energy market rules, industry regulation and general competition regulation.’ (MCE Communique, Perth, 11 December 2003, p1).

Governance and market institution performance are currently being reviewed under the auspices of the CoAG Energy Council.

3. *Comparing the allowed return on equity and actual profits, and comparing the tax charged set by the AER and paid by consumers and the actual tax paid, we see big gaps to the benefit of the industry. Why has the AER not had regard to this in putting forward more fundamental changes to the system of regulation?*

The current regulatory framework is based on a forward looking ‘incentive based’ regime. This means that the amount of regulated revenue that network businesses are allowed to recover from customers over the regulatory period is set up front. If a business can provide the required services at an actual cost below the efficient cost that we assess, the business can ‘keep the difference’ for a period of time. Conversely, if the network business incurs higher actual costs than we assessed, it will bear the difference. This is designed to encourage network businesses to minimise their costs while continuing to meet stipulated reliability standards.

After completing the first round of regulatory determinations in the National Electricity Market we were able to identify shortcomings in the rules underpinning the incentive based regime. We consider that the changes we proposed to the rules were significant, covering how rates of return were set, how capital expenditure and operational expenditure allowances were set, and regulatory processes.

We did not put forward more fundamental changes to the system of regulation, because we consider that an incentive based regime remains appropriate. The alternative, of regulating on the basis of actual costs and profits, does not provide an incentive for network businesses to operate efficiently and minimise costs. It also provides no incentive for network businesses to innovate; for example, it incentivises businesses to build networks rather than consider demand side options. Because of these issues with a cost of service approach, the trend around the world is to move towards an incentive based regulatory framework.