

# **Economic Regulatory Framework Review**

**Response to AEMC Approach Paper**

14 February 2019

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## Overview

### Key messages

1. The network sector supports regular evidence-based reviews and ‘stress testing’ of the network economic regulatory framework in the light of rapidly emerging consumer, market and technology developments
2. These reviews need to recognise the value to consumers of the role regulatory predictability and stability of outcomes plays in supporting low-cost financing of network infrastructure, meaning any significant potential changes should be carefully evaluated, evolutionary and tested
3. Networks support further exploration of potential evolutionary approaches to regulatory allowance setting and incentive frameworks where long-term benefits can be demonstrated
4. Networks support the ongoing monitoring undertaken by AEMC tracking metrics relevant to networks growing role as a two-way platform, with the ability to connect and distribution energy hosting capacity being key metrics

Energy Networks Australia (ENA) welcomes the Approach Paper published by the Australian Energy Market Commission (the Commission) on 17 January 2019.

Network businesses consider the review is a valuable opportunity to identify emerging impacts of market, technology, regulatory developments on the capacity of the economic regulatory framework to promote the achievement of both the immediate and long-term interests of network customers.

The annual review cycle provides an opportunity for the Commission to evaluate in a staged and iterative way some of the most significant trends, impacts, and opportunities for strengthening of current frameworks alongside evidence for recommending changes to the regime.

Such a holistic review enables a robust evaluation of the entire framework recognising the cross-linkages inherent in an incentive framework, in contrast to the set of short and narrow issue-specific reviews that have occurred over 2018. This has included AER reviews of approaches to estimating inflation, regulatory tax allowances and productivity adjustments relating to forecast operating expenditure.

This response builds on the structure of the Approach Paper and provides some initial reflections on the focus areas and options for exploration set out by the Commission. Network businesses look forward to exploring these issues further with stakeholders through the consultation processes to be established.

## Evolving role of networks and providing the best outcome for consumers

The network sector supports regular evidence-led reviews and ‘stress -testing’ of the network economic regulatory framework in the light of rapidly emerging market and technology developments.

Energy network businesses agree that the best consumer outcome is for the cost of transition in the current energy market transformation to be kept as low as possible. An important element of this is a full and proper assessment of the benefits to customers. Recent customer experiences and outcomes of elements of the Power of Choice reforms, which networks highlighted at the time may involve substantial costs with unclear benefits, highlight this critical step.

The ENA-CSIRO Network Transformation Roadmap made four key findings around the policy and regulatory framework relevant to the Commission’s review. These were that:

- » There is an **opportunity for more consumer-centric frameworks**;
- » **Lighter-handed regulatory models** may be more feasible;
- » There is a role for closer consideration of, and thresholds for, tests of **emerging competition**
- » The regulatory framework needs to be **flexible to new types of services**;

It remains critical that the speed of regulatory reform keeps pace with customer needs and technology development.

This means that the Commission should continue to use the annual review cycle to actively investigate and progress significant regulatory reform areas even beyond those already identified for action by other market bodies or COAG Energy Council processes.

This is a critical element of the Commission’s assigned role in market development, thought-leadership and the provision of guidance and expert advice to other policy-makers.

## Implementing Finkel recommendations on network incentives

There is a careful balance required in the Commission’s review flowing from the need to recognise the role of regulatory predictability and stability of outcomes in supporting low-cost financing of network infrastructure. This means any potential changes should be carefully evaluated, evolutionary in nature and trialled or tested wherever feasible. The proposed regulatory sandbox arrangements provide opportunities in this regard.

## Findings from the 2018 Commission Review

The Approach Paper highlights that the Commission has found in its 2018 review that there is no clear systematic bias in favour of either capital expenditure or operating expenditure in the current regulatory framework. Financial incentives in individual project circumstances will differ based on asset lives, the allowed rate of return and other factors.

In taking forward consideration of the issue of network incentives the Commission should take into account the likely impact these incentives of the outcomes of AER Rate of Return Guideline reached in December 2018, as well as the discussion of the AER's approach to assessing the magnitude and willingness of consumers to bear impacts of investment risk discussed in that decision.

For example, the AER states:

*We accept submissions from consumers that they prefer not to see a reduction in reliability and service standards and a higher risk of outages. However, the CRG [Consumer Reference Group] goes on to submit that consumers are willing to accept the risk of lower rate of return because they consider the consequential risk to network performance is low. In reaching this view, the CRG cites flat demand, excess capacity and good current levels of performance by networks. It considers that even if investment is below ideal levels there is unlikely to be an immediate impact on network performance. We cautiously accept this submission.<sup>1</sup> (emphasis added)*

The 2018 Guideline has reduced the allowed return on equity to the lowest level ever allowed by the AER, in the single largest reduction to date in the allowed return on equity applying to network assets. Previous work undertaken in the area of network incentives has identified that at discount rates lower than 6.0 per cent, there may be an incentive created by current arrangements to inefficiently substitute operating expenditure for capital expenditure. This incentive has the potential to unnecessarily raise network costs for current consumers.<sup>2</sup> Applying the AER's current guideline approach in early February results in an allowed return on equity of approximately 5.9 per cent.

The Commission's review, therefore, needs to consider that addressing the issue of appropriate network incentives in a forward-looking way relevant to the actual circumstances resulting from AER decisions may differ substantially from historical Commission and policy-maker considerations of the direction and strength of potential capital biases.

In this regard, ENA notes that capital expenditure on a network industry basis is at decade lows. Similarly, a review of the Commission's 2018 assessment of network operating/capital cost ratios, made prior to the AER's final rate of return guideline,

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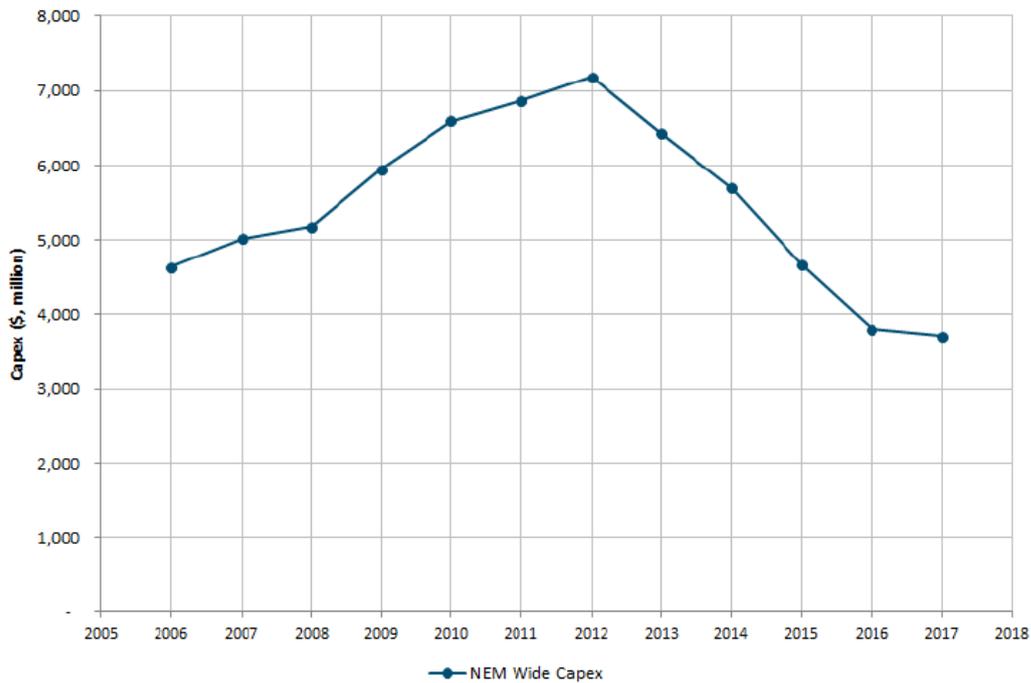
<sup>1</sup> AER Rate of Return Guideline – Explanatory Statement, December 2018, p.413

<sup>2</sup> KPMG *Optimising Network Incentives*, September 2017, p.73

provides little empirical support for an ongoing systematic capital expenditure bias of a kind that could impact efficient outcomes for consumers.

The AEMC's 2018 economic regulatory review report indicated that capex expenditure has *reduced* markedly in 2013 and thereafter. Indeed capex currently is the lowest on record, as shown in [Figure below](#).

**Figure 1: Reduction in CAPEX expenditure since 2013**



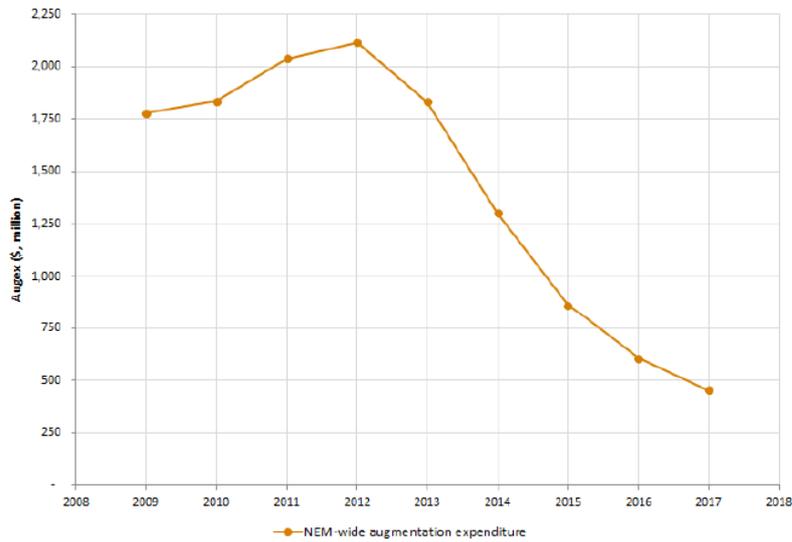
Source: AER

Note: values in 2017 real dollar terms.

Source: AEMC, 2018, *Promoting efficient investment in the grid of the future*, Figure 3.3, p. 41.

The AEMC also reports that augmentation capex has reduced to less than a quarter of 2012 levels, as shown in [Figure](#) overleaf. That is, more than 85% of the (lower) 2017 capex relates to the replacement of existing assets.

**Figure 2: Reduction in augmentation CAPEX expenditure since 2013**



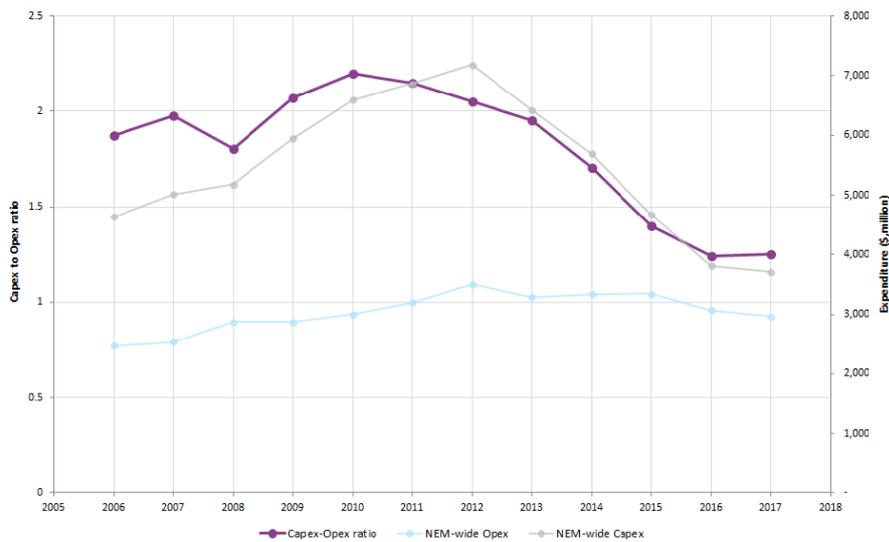
Source: AER

Note: values in 2017 real dollar terms.

Source: AEMC, 2018, *Promoting efficient investment in the grid of the future*, Figure 3.5, p. 43.

Figure shows that the reduction in capex results in a material decline in the capital/operating expenditure ratio as businesses reduce their relative expenditure on capital assets.

**Figure 3: Reduction in capex/opex ratio since 2013**



Source: AER

Note: values in 2017 real dollar terms

Source: AEMC, 2018, *Promoting efficient investment in the grid of the future*, Figure 3.12, p. 50.

This evidence is very clearly inconsistent with the proposition that there is a strong systematic bias towards capital expenditure due to the regulatory framework. Rather, the evidence shows that there has been a very pronounced move away from capital expenditure even in the period since the 2013 Guideline, with the incentives for that move reinforced by the 2018 guideline.

Networks recognises that capital expenditure is also affected by considerations including demand and load shape. Thus ENA does not suggest that the material reduction in investment since 2013 is entirely related to the reduction in allowed returns at that time. Rather, ENA simply notes that the evidence is clearly inconsistent with the proposition that allowed returns since 2013 have driven inefficiently high levels of capital expenditure, or that the operation of the network incentive framework has resulted in an identified upward bias in capital expenditure.

## Alternative approach to expenditure assessment and remuneration

ENA supports the 2019 review continuing to focus on exploration of alternative revenue-setting models and approaches.

Development and testing of any alternative models will require a lengthy period of consultation and engagement with stakeholders. This could occur in a staged multi-year process, recognising the relatively short annual cycle of the Commission's current reviews.

The regulatory sandbox arrangements proposed for consideration in the review provides an additional future route to test and trial any alternative revenue-setting approaches on a voluntary basis, for example across on network or a sub-set of regulated services

As part of development of any alternative revenue setting arrangement, ENA considers there should be:

1. Testing of alternative revenue-setting approaches (including any proposed by stakeholders in the review) against criteria clearly based on the National Electricity and Gas Objectives and Revenue and Pricing Principles;
2. Greater opportunities to give effect through the regulatory framework robust direct engagement between customers and networks on customer outcomes that are valued and how network business plans can deliver these;
3. Focus on opportunities to voluntarily trial and refine such approaches, rather than a single application of new approaches on an undifferentiated basis nationally.

The Approach Paper discusses the potential option of combining and simplifying the expenditure assessment rules. The current expenditure rules were reviewed and amended in 2012 by the Commission. At this stage ENA is not clear on any expected practical benefits of simply combining the rule clauses (which are markedly similar), whilst maintaining current separation of the building block elements in practice.

## Monitoring of current issues in the energy sector regulatory framework

ENA supports the proposed continuation of monitoring undertaken by AEMC.

To date this has principally encompassed allowed and actual expenditures, simple network utilisation measures, and RAB values, and these can help identify broad trends to inform policy making and regulatory decisions. The Approach Paper seeks input on other metrics that may be useful for the 2019 Review to consider.

ENA supports a widened set of metrics being tracked which are of greater relevant to networks' growing role as a two-way enabling platform.

Consistent with suggestions by the Commission, nationally consistent metrics tracking voltage or thermal constraints and the scale of limitations on DER connection applications would be valuable.

Further areas for potential metric development and tracking could also include:

- Expenditure on network monitoring and control – which can promote more effective network utilisation of existing infrastructure, which can support affordability outcomes
- Impacts on customer outcomes and investment flowing from the implementation of the 2018 Rate of Return guideline
- Longer term network financeability under different market trends, including a continuation of the currently observed trend towards greater use of operating expenditure
- How electricity distributors' steps toward fully enabling the ongoing energy transition are approached by the AER and how the costs and benefits are, and should be, assessed at a customer and community level.