



AER Submission

Expert Panel Review of Energy Access Pricing: Draft Report to the Ministerial Council on Energy

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Expert Panel Review of Energy Access Pricing: Draft Report

The Australian Energy Regulator (AER) welcomes this opportunity to comment on the Draft Report of the Ministerial Council on Energy's (MCE) Expert Panel Review of Energy Access Pricing.

As the Panel would be aware, the Commonwealth and State Governments have agreed to transfer responsibility for price regulation of electricity and gas distribution networks to the AER on 1 January 2007 (except in Western Australia and the Northern Territory). The AER will also continue with its current electricity transmission regulatory functions and will assume responsibility for the gas pipelines regulatory functions currently carried out by the Australian Competition and Consumer Commission (ACCC). The AER notes that the Expert Panel Review canvasses issues that are fundamental to these current and prospective responsibilities.

The Panel has engaged in a transparent process of public consultation and undertaken a balanced and robust assessment of the issues in its terms of reference. The adoption of the Panel's recommendations would improve the regulation of Australia's energy infrastructure and have subsequent benefits for users and service providers.

This submission makes comment on a small number of specific areas to assist the Panel in making its final recommendations..

In summary, the AER:

- agrees that separate legislative regimes should exist for gas and electricity, although with a common objective and structure
- supports the recommendation that objectives for both regimes should be to promote economic efficiency
- agrees that methodologies and guiding principles should exist for applying price and revenue caps
- believes that the process for choosing the form of regulation should be set in law, and that the body responsible for advising on coverage decisions (currently the National Competition Council) be responsible for recommending the form of regulation in the case of gas networks to the relevant Minister as decision maker
- supports the recommendation that the propose-respond model should not feature in either regime
- considers that it is not necessary to review chapter 8 of the new Gas Rules at this time
- proposes that regulator-issued guidelines should be recognised in law, along with penalty provisions to ensure compliance.

The legal and regulatory framework

The AER agrees with the Panel's conclusion that there are differences in the gas and electricity sector that justify separate regimes, but that certain elements of service delivery in each sector are sufficiently similar for gas and electricity law to contain

common features such as objectives and procedures. Such consistency should improve the administration of both regimes.

The AER also agrees with the Panel's conclusion that the nature of determining the appropriate balance between prescription and discretion does not allow for any practical guidance to be set in law. As an alternative, it may be useful for governments and policy advisory bodies to provide guidance on this issue during the rule making process.

It is not necessary to review chapter 8 of the new Gas Rules at this time. The Gas Code has been subject to a number of recent reviews, including by the PC and the Expert Panel, and is currently under consideration by the MCE in the establishment of the new Gas Rules. The AEMC's standing ability to consider rule change proposals should be sufficient to account for any difficulties, if and when they arise.

Objectives of the regimes

The AER agrees with the Panel's recommendation to set a common objective for both regimes that focuses on achieving economic efficiency. The AER's decisions are based economic efficiency and it is appropriate that the legislation contain an explicit objective stated in the same terms. Objectives or outcomes which focus exclusively on competition or consumer interests may simply coincide with maximising efficiency and community welfare. Pursuing 'efficiency' under any of its economic interpretations, however, necessarily ensures that welfare is improved.

Selection of the form of regulation

The selection of the form of regulation, like that for coverage, can have a significant impact on investment decisions, and recommends that associated provisions be set in law rather than in rules. The process involved in choosing between the forms of regulation should be administratively simple and incorporate clear selection criteria, otherwise the costs of allowing this choice may be larger than the benefits. The AER agrees with the Panel's criteria for assessing the degree of market power, although is unsure whether this would be simple to apply in practice. Alternatively, a more effective test may be to compare the net benefits of each alternative in choosing the form of regulation.

Given the similarities involved in determining coverage, the coverage advisory body (currently the National Competition Council) should be responsible for recommending the form of regulation to apply to regulated gas networks, with the relevant Minister responsible for the decision. This view is consistent with the PC's recommendations for the gas access regime.

The Panel's considerations correctly recommend the establishment of common legislative regimes (where this is justified) emphasising that the context of each situation will determine the appropriateness of price monitoring as a form of regulation. A relationship exists between the decision to regulate and the form of regulation to apply. The current coverage test ensures that regulation is only applied

to networks that possess substantial market power and it follows that these networks should be subject to effective regulation. The coverage provisions in the Gas Code are broadly similar to the declaration criteria of Part IIIA of the *Trade Practices Act*. If a gas network meets the coverage criteria it is likely that it would also satisfy the declaration test. The Panel notes that price monitoring would only be appropriate where market conditions are unlikely to be subject to declaration. Given the correspondence between the coverage and declaration tests, this means that price monitoring would only be appropriate for pipelines that do not pass the coverage test.

Price monitoring may be an effective regulatory tool in some circumstances, although this depends on how it is designed and implemented, including clear objectives to guide its selection. The ACCC recently commissioned Allen Consulting Group to review price monitoring and its related elements, and the conditions under which it would be effective. This report will be forwarded shortly.

Decision making framework

The AER agrees that there should be no presumption that the regulator be required to accept a proposal offered by a service provider, and also agrees with the Panel's conclusions regarding the role of ranges and estimates in regulatory decisions. Concepts of presumption and reasonable/plausible range and reasonable estimate, would:

- be practically difficult to implement— it would effectively require the regulator to determine (upper and lower bound) estimates of each parameter and assess a wide variety of pricing methodologies across each regulated business
- open the process to added complexity and litigation— the terms 'reasonable' and 'plausible' are vague, and provide no guidance for assessing parameter estimates or the methods used to derive them
- result in the submission of ambit claims— businesses have no incentive to submit a proposal, accurate or otherwise, prior to discovering the regulator's perception of what is reasonable or plausible.

The complexities involved in deciding on these issues, including possible litigation, would create similar costs for the AER and regulated businesses, while uncertainties over the interpretation of these concepts would have further effects on investment decisions, service standards and prices. The 'restricted' propose-respond model addresses the incentive to submit ambit claims but not the problems of undertaking reasonableness assessments and of administrative complexity.

A propose-respond model would increase the regulatory burden for the AER by restricting its ability to implement a streamlined approach for the 40 network service providers for which it will eventually be responsible. Benchmarking approaches such as Total Factor Productivity (TFP) would also be difficult to implement under a propose-respond model as businesses that are unwilling to outperform benchmarks would be free to propose other methods with weaker incentives.

These problems can be avoided by requiring the AER to assess the service provider's proposal against the legislation's objectives.

As noted by the Panel, the concept of ranges and the presumption of acceptance have arisen in the absence, not the presence, of a clear directive in the legislation. Such a directive, either in the form of a MCE statement of policy or a specific legal provision, therefore appears necessary.

The AER also agrees with the Panel's finding that the use of ranges would result in a bias in favour of businesses. The introduction of such a bias would not be a 'first best' policy solution to the 'problems' of regulatory error and uncertainty. Improvements to coverage provisions and certification processes, by targeting greenfields investments, would be preferable than introducing distortions to assessments of appropriate regulatory returns. Requiring the AER to explicitly account for the risks and costs of inefficient investment and usage, and allowing it to collect relevant information from service providers, would also better address concerns of regulatory error.

There is merit in requiring the AER to develop guidelines that bind the AER and regulated businesses to using certain procedures or parameters for a fixed period of time. This has the potential to reduce the scope for re-consideration of issues during each reset which otherwise diverts resources away from consultation and analysis of more important issues. The ability of the AER to issue such guidelines should be recognised in law.

Application of price controls

The AER agrees with the Panel's comments that the similarities between gas and electricity networks are sufficient to implement the same methodologies and guiding principles for setting price and revenue caps. The pricing principles suggested by the Panel appear appropriate in this regard.

The AER supports the Panel's recommendation that pricing principles be implemented through an approach based on section 35 of the National Electricity Law (NEL). The AEMC should ensure that the rules relating to revenue regulation implement the pricing principles set out in the NEL and the National Gas Law (NGL). The AER must make determinations in accordance with these rules. There is no need to separately apply these principles to the AER. Such a measure can only lead to confusion about the principles to be applied by the AER in a regulatory determination. To this end, the AER supports the Panel's recommendation that section 16 be deleted from the NEL and that no corresponding provision be enacted in the NGL.

The AER also agrees that provision should be made in law for the use of TFP information. Regulators should be empowered to collect the data necessary to conduct such a review in the future, including through the issuing of information requests that are binding on service providers. It is uncertain that the review deadline proposed by the Panel would be sufficient to allow the timely collection of such information. Stakeholders should have the opportunity to discuss the issue before any review dates are set.

Information requirements

Regulated businesses are best placed to know their own costs and operating environment, hence the information they provide is essential in making price determinations. Current legislative powers are limited in being able to require businesses to maintain information in a form that is useful to the regulator, resulting in regulators beginning with a 'blank sheet' at each price reset. Periodic reporting would facilitate the identification of areas of concern prior to the reset process, allowing stakeholders to focus their discussion and reduce the administrative burden and inefficiencies of ad hoc inquiries.

The ability of the AER to establish standardised reporting frameworks will be crucial as it gains responsibility for all regulated energy networks over the next several years. In this context, information gathering powers and responsibilities should be aligned as far as possible across the gas and electricity regimes. As noted by the Panel, the constraints in being able to obtain relevant information under gas legislation are significant and must be addressed. Particular problems and uncertainties exist in both regimes on the treatment of cost allocation, including the presence of related party contracts.

The AER agrees with the Panel's comments that the cost of increased information requirements should be compared against the benefits of setting prices and revenues through better analysis and the market power held by service providers.

The Panel should consider the implications of the AER issuing information guidelines. In particular, these guidelines would need to be binding on service providers and have corresponding provisions in law, including adequate penalties, to ensure compliance.