



Response to the AER Draft Shared Asset Guidelines

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1 Executive summary

The Energy Networks Association (ENA) welcomes the opportunity to provide a response to the Australian Energy Regulator's (AER) *Draft Shared Asset Guidelines for electricity distribution and transmission*.

The ENA wishes to indicate its strong support to the primacy of the first shared asset principle, which at cl. 6.4.4(c)(1) and cl. 6A.5.5(c)(1) of the *National Electricity Rules* (Rules) provides that Network Service Providers (NSPs) should be encouraged to use regulated assets for the provision of unregulated services where that use is efficient.¹ If the guidelines do not deliver on the first shared asset principle, there is a real risk that NSPs will be discouraged from undertaking unregulated activities using shared assets. This may lead to inefficient use of the regulated infrastructure and the foregoing of significant consumer benefits through a dispersion of costs.

The ENA broadly supports the approach that the AER has proposed in the Draft Shared Asset Guidelines, including its shared asset cost reduction method. However, the ENA recommends that the AER reconsiders several of its proposals, which may limit the utility of the guidelines. Specifically, we consider that:

- The AER should not seek to impose a threshold for application of alternative shared asset cost reduction methods through the guidelines as this would be inconsistent with the process established in the Rules for departure from the approach set out in the guidelines.
- The AER's proposed cost reduction method reduces NSPs' annual revenue requirement by around ten per cent of shared asset unregulated revenue. The ENA considers that this level of reduction is at the upper limit of a reasonable reduction that maintains appropriate incentives to offer additional services from shared assets.
- The AER should provide blanket confidential status to contractual information provided under the Shared Asset Guidelines. This is because this information relates to an activity not regulated by the AER under the Rules and release of confidential information in public domain may expose NSPs to breach of contract, create a disincentive for third parties to contract with the NSPs, or constrain the negotiating power of NSPs in relation to these services.
- The approach that the AER proposed in order to address the circumstances where there is a marginal use of regulated assets for provision of unregulated services in section 3.3.1 of the *Explanatory Statement* should be included in the guidelines. In particular, the AER proposed that the NSPs should apportion unregulated revenues to reflect the extent to which unregulated services rely on shared assets. However, this does not appear in the Draft Shared Asset Guidelines. This is a key point that should be covered in the guidelines as well as the Explanatory Statement.

The ENA notes that the consideration of incremental costs is outside of the AER's Draft Shared Asset Guidelines and does not propose any changes to the guidelines to address this matter. It is not obvious that all possible methods that account for incremental costs would necessarily be in breach of the Rules, as suggested by the AER. If the NSPs choose not to apply the guidelines methodology and make an alternative sharing proposal that gives reference to incremental cost, the consistency with the Rules should be considered at the individual determination stage.

The remainder of this submission expands on the concerns outlined above and also provides comments on other aspects of the AER's draft guidelines. The specific recommended changes to the AER's Draft Shared Asset Guidelines are outlined in [Attachment 1](#).

¹ Shared asset provisions of the Rules relate to distribution standard control services and prescribed transmission services. These services are referred to as regulated services throughout this submission. All other services are referred to as unregulated services.

2 Background

The Australian Energy Market Commission's (AEMC) Rule Determination in respect to Economic Regulation of Network Service Providers, published in November 2012, introduced a requirement on the AER to develop and consult on Shared Asset Guidelines for electricity transmission and distribution businesses. The Shared Asset Guidelines will be non-binding on the NSP and the AER. Following the completion of this consultation process, the AER may review, amend or replace the Guidelines in accordance with distribution and transmission consultation procedures under the Rules.

The Rules require that the Shared Asset Guidelines set out the approach the AER proposes to take in applying the shared asset principles. This may include a methodology that the AER proposes to use to determine shared asset cost reductions. In making a decision on shared asset cost reduction, the AER must have regard to the guidelines and the shared asset principles.

3 AER's proposed approach

3.1 Materiality threshold

The shared asset principles provide that the AER should make a shared asset cost reduction where the use of the asset for provision of unregulated services is material.² The AER has included a materiality threshold of one per cent of the annual revenue requirement as a proxy of "material use" in its draft guidelines. Therefore, the shared asset cost reduction method will not apply in the circumstances where the materiality threshold has not been reached.

In its submission to the AER's Issues Paper, the ENA suggested that the NSPs should be able to demonstrate materiality based on the assessment of physical use, if required. It is understood that the AER's proposed approach represents a simple, cost-effective and transparent way of applying the relevant shared asset principle in the context of the guidelines. Also, some NSPs may have limited information to determine physical use. On the other hand, this approach will capture unregulated services that use regulated assets in a very limited way, which may discourage the efficient use of some assets. That is why it is important the AER includes the relevant words around marginal use of the shared assets as set out in 3.3.1 of the *Explanatory Statement* in the guidelines. The assessment mentioned in 3.3.1 should take place in advance of the materiality threshold stage.

On balance, members of the ENA are comfortable with the approach proposed by the AER.

3.2 AER's proposed cost reduction approach

The ENA considers that at least one methodology should be outlined in the guidelines. On this point, the AER's draft guidelines deliver certainty as to the approach that can potentially be applied at the determination stage.

The AER's proposed cost reduction method is quite simple in its application. Where the materiality threshold is reached, the AER will reduce an NSP's annual revenue requirement by around ten per cent of the value of unregulated service earned with shared assets.³ The ENA agrees with the AER that the benefits of this approach are its simplicity and transparency.

The important feature of the AER's proposed method is a percentage of sharing. The AER proposed to reduce the NSP's annual revenue requirements by approximately ten per cent of shared asset unregulated revenues. The ENA considers this reduction to be the upper limit of a reasonable reduction that maintains appropriate incentives to offer additional services from shared assets while

² National Electricity Rules, cl. 6.4.4 (c)(3) and cl. 6A.5.5 (c)(3).

³ AER, Explanatory Statement, Draft Shared Asset Guidelines, p.20.

not prejudicing the provision of regulated services. Any sharing proportion higher than ten per cent of shared asset unregulated revenue would be unreasonable given that the AER's guideline methodology does not consider the incremental costs associated with the provision of shared asset unregulated services. Larger sharing proportions would act as a powerful disincentive for NSPs to offer unregulated services with shared assets and is likely to drive inefficient behaviours inconsistent with the National Electricity Objective. For example, it may mean:

- Additional costs and administrative burden to both NSPs and the AER of considering alternative sharing proposals outside the guidelines;
- NSPs will withdraw from the provision of unregulated services where they become less viable (where they are able), foregoing opportunities for consumer benefits through a reduction in costs;
- NSPs will (otherwise inefficiently) substitute away from the use of regulated assets that are not relied on for the provision of unregulated services, again foregoing the opportunity of consumer benefits through a reduction in costs.

In its *Explanatory Statement* the AER suggested that it accepts that the NSPs incur additional costs from providing unregulated services with shared assets. These costs can be significant and support a sharing proportion of no greater than ten per cent.

3.3 Threshold for application of alternative cost reduction methods

In its draft guidelines the AER, in effect, imposes a threshold for application of alternative cost reduction methods. The nature of this threshold is that the AER's proposed cost reduction method is treated as a default. If an NSP proposes to use an alternative method, it must demonstrate that consumers would not be worse off relative to the AER's method.

The ENA disagrees with this specific aspect of the AER's draft guidelines. It is the role of the Rules to define the circumstances in which the guidelines will apply, and this cannot be done through the guidelines. The Rules simply provide that the AER must have regard to the shared asset principles and shared asset guidelines when making a shared asset cost reduction.⁴ The Rules further provide that the guidelines are non-binding and a departure can be initiated by either the regulator or the NSPs. The AER's approach would be inconsistent with the design and legal hierarchy of the regulatory framework in this area.

The ENA also notes that flexibility in the Rules provides for multiple methods to be assessed to derive outcomes which are consistent with the Rules. Given this, it should be open to each NSP to either adopt the methodology set out in the Shared Asset Guidelines, or propose a different methodology where it considers this is warranted. In deciding whether or not to adopt an alternative methodology, the AER should only be guided by the requirements of the Rules, and any applicable requirements of the *National Electricity Law*. This means that:

- the AER should consider whether the alternative methodology meets the requirements of cl. 6.4.4(a) and cl. 6A.5.5(a);
- as with all of its functions and powers, it should undertake this task in a way that will or is likely to contribute to the achievement of the National Electricity Objective;⁵ and
- in exercising any discretion, the AER should take into account the revenue and pricing principles.⁶

⁴ National Electricity Rules, cl. 6.4.4 (b) and cl.6A.5.5 (b).

⁵ National Electricity Law, s 16(1).

⁶ National Electricity Law, s 16(2).

For the reasons outlined above, the AER should not seek to impose any further constraints on this decision, through the Shared Asset Guidelines themselves.

3.4 Services that use regulated assets only marginally

The AER has provided guidance in respect of services that do not rely on the use of shared assets in section 3.3.1 of the *Explanatory Statement*, recognising that unregulated services may use shared assets in a very limited way. The AER has indicated that in such cases service providers should focus on the unregulated revenue stream derived from an unregulated service, and apportion unregulated revenues to reflect the extent to which unregulated services rely on shared assets. Service providers will need to set out their reasons for apportioning revenues and the basis on which they have done so. Where the apportionment reasonably reflects shared asset use, the AER will accept it as an element of their cost reduction determination.⁷

The ENA supports the concepts expressed in this section of the *Explanatory Statement*. As noted above, a reasonable apportionment of revenue is crucial to ensuring that the use of revenue as a materiality test is appropriate, and to give effect to clauses 6.4.4 (c)(1) and (3) (6A.5.5 (c)(1) and (3)) of the Rules.

For clarity, the guidance provided in section 3.3.1 of the *Explanatory Statement* should be included in the final guidelines.

4 Incremental costs

Whilst the ENA accepts the method for sharing that the AER proposed to set as the default by setting it in the guidelines, the ENA does not agree with the position in the *Explanatory Statement* that a method which takes into consideration incremental costs must be inconsistent with the Rules.

A method which accounts for incremental costs would not necessarily breach the shared asset principle contained within cl. 6.4.4 (c)(2) and cl. 6A.5.5 (c)(2). The principle states that the making of a shared asset cost reduction is not *dependent* upon the service provider deriving a positive commercial outcome from the use of the asset other than for regulated services. The ENA considers that taking into account incremental costs does not imply that a shared asset cost reduction is dependent on the service provider deriving a positive commercial outcome from providing other types of services, since it does not create a direct link or dependence between the level of profitability on unregulated services and the scope for revenue reduction.

The ENA requests that the AER re-examines its conclusions on this matter. At the individual determination stage, an NSP may identify an approach that accounts for incremental costs that is advantageous for treatment in particular circumstances. A general statement in the final *Explanatory Statement* which dismisses the approach, without full rigour, would likely undermine its later application.

5 Reporting requirements

The ENA notes the proposed reporting requirements and appreciates the consideration the AER has given to balancing the administrative costs of reporting with the level of information required to perform an assessment. The ENA does not support any additional reporting over that proposed in the draft guidelines as the information requested appears to be sufficient to determine an amount of sharing.

The ENA also notes that the AER has requested an overview of contracts under which the NSPs earn unregulated revenues. While it is understood that some information on unregulated services is necessary, this information relates to an activity not regulated by the AER under the Rules. The ENA

⁷ AER, *Explanatory Statement*, Draft Shared Asset Guidelines, p.32.

understands that the AER intends to apply the confidentiality guidelines to any information provided for assessment of shared asset revenues. Many of these contracts contain specific confidentiality provisions and industry is concerned that under the current Draft Confidentiality Guidelines the AER may decide to publish confidential information which may expose NSPs to breach of contract or create a disincentive for third parties to contract with the NSPs.

In view of the above, the ENA considers that the AER should provide blanket confidential status to contractual information provided under the Shared Asset Guidelines.

Attachment 1 Proposed amendments to the draft guidelines

Amend 3.1 Cost allocation and shared assets

The lists in paragraphs 3.1 (a) and 3.1 (b) appear to be cumulative, but the guidelines should be amended to include “and” (or “or” if appropriate) to remove any doubt.

Amend 3.1 Cost allocation and shared assets

Clarify the term that refers to assets as ‘established’ in 3.1 (a)(i) and the term that refers to assets as “new” in 3.1 (b)(i). The ENA considers that “new” shared asset is one that commenced earning unregulated revenues in the current regulatory control period (i.e. the period preceding the one for which the AER is undertaking a distribution or transmission determination process). That means an “established” asset is one that is already earning unregulated revenues at the commencement of the forthcoming regulatory control period.

Amend 3.3 Service providers may propose cost reduction

Remove the last sentence in cl. (d). In deciding whether or not to adopt an alternative methodology, the AER should only be guided by the requirements of the Rules, and any applicable requirements of the National Electricity Law. This means that:

- the AER should consider whether the alternative methodology meets the requirements of cl. 6.4.4(a) and cl 6A.5.5(a);
- as with all of its functions and powers, it should undertake this task in a way that will or is likely to contribute to the achievement of the national electricity objective,⁸ and.
- in exercising any discretion, the AER should take into account the revenue and pricing principles.⁹

Amend 5.2 Regulatory proposal reporting

The AER should provide blanket confidential status to contractual information provided under the Shared Asset Guidelines as this information relates to an activity not regulated by the AER under the Rules.

Insert 4.5 Services which use shared assets only marginally

In section 3.3.1 of the Explanatory Statement the AER suggests the NSPs can apportion unregulated revenues to reflect the extent to which unregulated services rely on shared assets. However, this does not appear in the draft guidelines. This is a key point that should be covered in the guidelines as well as the Explanatory Statement. The ENA proposes that the AER inserts the relevant words from section 3.3.1 of the Explanatory Statement into the guidelines.

⁸ National Electricity Law, s 16(1).

⁹ National Electricity Law, s 16(2).