



18 April 2018

Senior Committee of Officials
Council of Australian Governments
Energy Council

Via email: energycouncil@environment.gov.au

Dear Senior Committee of Officials,

RE: Submission to the Council of Australian Governments Energy Council on the proposed binding rate of return amendments

Infrastructure Partnerships Australia (IPA) is pleased to respond with this submission to the Senior Committee of Officials of the Council of Australian Governments (COAG) Energy Council on the draft Statutes Amendment (National Electricity Laws) (Binding Rate of Return Instrument) Bill 2018 (the draft Bill).

As Australia's peak infrastructure body, representing public and private infrastructure owners and operators, we are eager to contribute to this consultation process and respectfully request that the impacts of proposed legislative amendments be carefully considered within the long-term context of the energy market.

Our submission focuses particularly on three key points:

1. The need for robust and stable regulatory frameworks;
2. Ensuring fair and transparent accountability; and
3. Securing long-term investor certainty.

More specifically, we discuss how the draft Bill's proposed amendments relating to the calculation of rate of return on capital will have a significant impact on investor confidence in regulatory frameworks for electricity network businesses, the energy market and the broader infrastructure sector.

RECOMMENDATIONS

1. The COAG Energy Council should **not** support the draft Statutes Amendment (National Electricity Laws) (Binding Rate of Return Instrument) Bill 2018 in its current form.
2. The COAG Energy Council should develop a policy paper outlining the desired policy goals to be achieved through the legislative amendments relating to the rate of return on capital. The paper should be agreed upon by members of the COAG Energy Council and released for public consultation, before being used to inform the drafting of new legislative amendments.
3. Future redrafting of the legislation should ensure that the changes to the rate of return framework guarantee appropriate regulatory checks and balances, incorporate the fundamental guidance principles set out in the rules, and maintain consistency with the Australian Energy Market Agreement.



CONTEXT

Economic regulatory frameworks for energy network businesses have experienced several years of substantial change and uncertainty. The proposed amendments to the National Electricity Law (NEL) and National Gas Law (NGL) continue the trend of increasing instability. Furthermore, if the proposed amendments proceed, they will have a detrimental impact on achievement of the National Electricity Objective (NEO) and National Gas Objective (NGO).

The most recent change to the regulatory framework occurred in October 2017, when the Commonwealth Government unilaterally abolished the Limited Merits Review (LMR) regime.

IPA has submitted previously on this topic and we attach the following for additional context:

- [Submission to the Senate Standing Committee on Environment and Communications on the Abolition of the LMR Regime](#) (22 September 2017);
- [Submission to the Minister for Energy on the Review of the LMR Regime](#) (16 March 2017); and
- [Submission to the COAG Energy Council on the Review of the LMR Regime](#) (2 October 2016).

With regard to the rate of return framework, a series of amendments were introduced in 2012 that resulted in a consistent set of rules, processes and guidance for the determination of the rate of return and a non-binding rate of return guideline. The process was comprehensive and these rules have since been scrutinised through the LMR and judicial review processes, establishing valuable precedent and certainty for investors.

The current proposed changes in policy, as outlined in the draft Bill, and changes to the National Electricity Rules (NER) and National Gas Rules (NGR) (the Rules) will ultimately remove the guidance contained in the Rules and provide the Australian Energy Regulator (AER) with almost complete discretion in making a binding rate of return instrument.

This unexpected policy proposal will only exacerbate the already heightened concerns of investment risk in electricity networks following the abolition of the LMR regime.

KEY POINTS

In this section we discuss several specific concerns arising from the draft Bill, which conflict with the stated aim of achieving the NEO and NGO. As an overarching comment, we submit that the flaws within the draft Bill stem from the absence of an agreed policy direction to help guide the proposed amendments.

The need for robust and stable regulatory frameworks

Determination of the rate of return has a profound impact on network businesses' ability and incentives to invest and as a result the services received by their customers. For this reason, it is important that appropriate checks and balances remain part of the framework used to calculate this cornerstone figure.

With the abolition of the LMR regime, the only avenue of appeal in relation to regulatory decisions made by the AER is judicial review. Significantly, judicial review does not provide the same level of accountability for the regulator as the LMR regime, as it is only applicable where errors of process have been made, whereas LMR considers the fundamental merits of a decision (even if the correct process had been followed).

We submit that not only is judicial review insufficient as an appeals mechanism when contemplating the introduction of a binding rate of return instrument, but even this last element of accountability may be entirely compromised if the proposed amendments in the draft Bill are adopted.

The draft Bill proposes legislation that provides the AER with comprehensive discretion in formulating the binding rate of return instrument. This means that by setting the instrument, the AER is effectively setting law, leaving few circumstances under which judicial review could be accessed, given that it only applies where an error of process or error of law has occurred.

Moreover, although the draft Bill sets out a process for the making of the instrument, which includes; reference to an independent expert panel, reference to a consumer reference panel, several rounds of public consultations and adherence to revenue/pricing principles; proposed section 18R of the NEL and section 30M of the NGL, states that *“a failure to comply with any of these requirements, however, does not affect the validity of the instrument”*. This unusual provision is in direct conflict with any policy objective of providing confidence to investors, as it appears to undermine the required procedural steps in the guideline making process.

For these reasons, the proposed amendments under the draft Bill would be unchallengeable, given the discretion offered to the AER in formulating the instrument and the limited avenues for appeal that exist under judicial review.

The draft Bill proposes that the framework for rate of return be elevated into the NEL and NGL, which would see the framework removed from the Rules. As set out in the Bulletin, released by the Senior Committee of Officials, the rate of return framework would be deleted from the Rules, but much of the guidance provided by these rules will not be transplanted into the corresponding Laws.

The draft Bill proposes the removal of several pieces of guidance from the framework, the most notable of which include:

- the requirement for the allowed rate of return to be commensurate with efficient financing costs of a benchmark efficient entity; and
- the requirement to use a weighted average cost of capital (WACC) approach.

The removal of these fundamental elements of the rate of return rules would leave the new framework ill-defined and with little reference to lessons learned through previous resolutions of complex matters of methodology. This approach would represent an unexpected degradation of the level of regulatory stability and predictability offered by the rule based framework, and is not a necessary part of delivering on the agreed policy goal of a binding guideline.

Ensuring fair and transparent accountability

Adoption of the changes within the draft Bill would see a blurring of the lines between the various responsibilities and functions of the National Electricity Market's (NEM) energy bodies. In particular, the draft Bill would remove the intentional separation, as outlined in the Australian Energy Market Agreement, between roles of policy, rule making, decision making and enforcement.

The Australian Energy Market Agreement¹ sets out a clear separation of powers between energy bodies, with the responsibilities and functions of the Australian Energy Market Commission (AEMC) and AER described below:

The AEMC

The AEMC is responsible for rule-making and energy market development at a national level. This includes all rule-making and market development functions for the electricity wholesale market, as well as distribution and transmission networks.

The AER

The AER is responsible for regulation and compliance at a national level. With its core economic regulation functions including monitoring and reporting on compliance with the NEL and the NER, as well as enforcing the NEL and the NER.

The Bulletin explains that as a consequence of removing the rate of return framework from the NER and NGR, the heads of power for the AEMC to make rules regarding the determination of a rate of return would also be removed. This would see the AEMC unable to perform one of its core functions, which is rule-making for distribution and transmission networks.

Instead, responsibility for rule-making, related to what must be considered and the methodology for calculating rate of return, will be transferred to the AER. This will see the AER become both the 'rule-maker and enforcer' for rules relating to rate of return, thus increasing the potential for conflicted objectives within the AER and diminishing protections for energy market participants. Furthermore, confidence in the independence of decision making is a fundamental aspect of a robust regulatory framework and the separation of powers and roles supports both actual and perceived independence.

We note that, as set out in the Bulletin, the AER is to have complete discretion in determining the composition of the consumer reference group and independent panel, with no guaranteed role for key stakeholders such as the relevant businesses. Given the AER's sole discretion in appointing experts to the panel, it is not credible to regard experts appointed to these bodies as "independent".

Another consequence of removing rule-making powers from the AEMC, would be that energy market participants, such as consumer/user groups, networks or other stakeholders would lose the ability to propose rule changes.

Securing long-term investor certainty

A settled, stable and predictable regulatory regime is critical to the maintenance of investor confidence in Australia's electricity networks and other national infrastructure.

¹ COAG Energy Council, Australian Energy Market Agreement, 2013
(http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/Australian%20Energy%20Market%20Agreement%20-%20Dec%202013_1.pdf)

Investment is important because it provides capital, asset management expertise and competition within markets, all of which assist in promoting the long-term interests of consumers and the achievement of the NEO/NGO.

In making long-term investments in regulated assets, investors will logically consider the regulatory regime that governs how much they charge. Uncertainty about the 'rules of the game' can increase the return on capital required by investors, which will increase the cost of new investments, as investors will need to factor in the risk that regulatory approaches may change substantially over the medium term (such as in future four yearly instrument reviews). This in turn will serve to further inflate the price consumers pay for energy.

Investors will look to the predictability and stability of Australia's regulatory environment to assess the risk of making new investments in Australia's energy sector, with a fair and defined framework for the calculation of rate of return being a key element of this assessment.

Further we note that the NEM and gas market are already under stress through a wide range of regulatory and political interventions, which means a predictable and stable regulatory framework is even more important. As discussed in an October 2017 survey of domestic and foreign infrastructure investors, conducted by IPA and Perpetual, three quarters of participating investors agree that the Australian energy sector is full of uncertainty. This uncertainty reflects market conditions, but also a multitude of government interventions in upstream gas, network price regulation, wholesale generation and retail energy².

Highlighting the impact of policy uncertainty on investment, one respondent to the investor survey stated that, *"government policy uncertainty is driving the uncertainty in the energy sector. The market is waiting for the energy sector to stabilise"*³.

CONCLUSION

Security, price and reliability of energy supplies are best addressed by promoting efficient investments and that means investors must have confidence the price setting regime is fair and well defined. Moreover, efficient investment in networks will be crucial in supporting the energy sector's broader transition both in terms of new policies and new technology.

The above criteria will not be met by the legislative amendments proposed by the draft Bill, as it contains several inadequacies stemming from the absence of an agreed policy direction. As a result of these inadequacies, the draft Bill would not help to achieve the NEO or NGO and therefore needs to be substantially revised. We therefore submit that the draft Bill in its current form should **not** be supported by the COAG Energy Council.

As a useful next step in making the legislative amendments, we recommend that the Senior Committee of Officials develop a policy paper setting out the intended goals of the legislative amendments relating to the rate of return on capital. These policy goals should then be agreed upon by the COAG Energy Council and then released for public consultation. Once the COAG Energy Council has settled on these policy goals, these goals should then be used to inform the drafting of the legislative amendments.

² IPA/Perpetual, Australian Infrastructure Investment Report, October 2017, page 10 (<http://infrastructure.org.au/wp-content/uploads/2017/10/Australian-Infrastructure-Investment-Report-2017-FINAL.pdf>)

³ Ibid, page 11

Thank you for your consideration of this submission, if you require any further detail please contact Lydia Robertson, Senior Policy Adviser, on (02) 9152 6011 or lydia.robertson@infrastructure.org.au.

Yours sincerely,

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