

2 July 2020

Australian Energy Market Commission
Project Reference Code EPR0085

Via website: www.aemc.gov.au

Re: Electricity network economic regulatory framework (ENERF) – Approach Paper

Spark Infrastructure has interests in some \$18 billion of electricity network assets, delivering energy to more than 5 million customers across the National Electricity Market (**NEM**). These interests include a 15% interest in TransGrid, the electricity transmission network in NSW; a 49% interest in SA Power Networks, the electricity distribution network in South Australia; a 49% interest in both CitiPower and Powercor, two of the electricity distribution networks in Victoria; and 100% ownership of the Bomen Solar Farm in NSW.

Spark Infrastructure provides long-term capital to support investment in a reliable and affordable low emission energy network. This investment is particularly critical in an energy system that is being disrupted by new technologies and that is transitioning to increasing levels of intermittent generation. Our role in the market helps keep costs low for consumers, through eliminating pricing disparities and facilitating entry of new low-cost generation and storage.

We are pleased to have the opportunity to contribute to the AEMC's 2020 ENERF review. We consider that the focus of this review should be on whether the current regulatory framework is stimulating the required levels of efficient investment and innovation that will deliver long term value to customers in terms of price and services. To ensure that capital is provided at the lowest cost, energy investors require a regulatory regime that provides confidence to invest efficiently. This can be achieved through stability, predictability and transparency of process and outcomes across multiple regulatory periods.

As part of this focus, we suggest further investigation of:

- **Incentives to deliver what customers value:** The regulatory framework should include sufficient and appropriate incentive mechanisms to respond to changing needs of customers. Network Service Providers (**NSPs**) should be incentivised to undertake investment that delivers outcomes valued by customers.
- **Recognition of the role of networks in price reductions:** Regulators and NSPs should be able to consider broader benefits when assessing network investment, including the expected price impact on end-consumers.
- **Financeability:** The regulatory framework should be updated to include a requirement for the regulator to ensure that the appropriate credit ratings can be maintained for the regulatory period and life of the project and that the revenue determination is sufficient to attract efficient capital commensurate with the associated risks.
- **Restoring confidence in outcomes:** An external review mechanism should be considered to re-instate principles of regulatory best practice and underpin confidence in decisions that have a significant impact on economic value and the community.

Regarding the issues canvassed in the ENERF approach paper, our views are as follows:

- **Efficient integration of distributed energy resources (DER):** For customers to receive the full benefits of DER, it is vital that network tariffs and incentives continue to be reformed. Incentive mechanisms could be more flexible so that they can be aligned to the changing needs of customers. This will ensure the impact and cost implications are treated fairly and equitably across all consumers, including those who do not, or are unable to, invest in DER. This reform is unlikely to be successful without the explicit support of government including targeted interventions for vulnerable retail customers and a transition period.
- **Dealing with large transmission investment and contingent projects in the context of Integrated System Plan (ISP):** It is well understood that the changing energy network requires sizeable new transmission infrastructure to deliver savings to customers. For these investments to go ahead, the revenue provided must be sufficient for NSPs to maintain the benchmark credit rating assumed in the regulatory framework and to attract efficient capital commensurate with associated risks. In the current environment of extremely low regulated returns, this is increasingly difficult to achieve and has led to financeability issues for large greenfield projects. It is vital that incentive mechanisms can be flexible and adapt to the increased risk for proportionately large expenditure programs and projects.
- **Risk allocation between distribution networks and consumers:** The risk of under-investment in transmission infrastructure is much greater than over-investment. Under the currently regulatory framework, NSPs are required to pay financing costs and a penalty even where the AER determines a particular 'over-investment' to be efficient. Consumers do not pay for inefficient investment and benefit from efficient over-investment. This imbalance of risk in a low return environment is not only contributing to the challenges of progressing large greenfield projects, but also dampening incentives for other regular investment across the energy network.
- **Need for enhanced consumer engagement:** NSPs have significantly enhanced their consumer engagement in the preparation of their proposals in revenue determination processes. What is not yet clear is the extent to which the increased consumer influence will be reflected in the subsequent AER decision-making processes. Further work on consumer engagement could include an assessment of the NewReg approach against the other contemporary engagement programs, including an assessment of the effectiveness of the NewReg Customer Forum as a vehicle for consumer views.

The attachment to this letter provides further information to support these areas of investigation. I would be happy to discuss these matters further and can be contacted on 0421057821.

Yours sincerely,



Sally McMahon
Head of Economic Regulation and Energy Policy
Spark Infrastructure

ATTACHMENT: SUPPORTING INFORMATION ON SUGGESTED AREAS OF INVESTIGATION

We consider that it is vital for the AEMC to consider whether the current regulatory framework is stimulating the required levels of efficient investment and innovation. In doing so, it is important to review the outcomes currently being experienced within the market.

For example, the ESB's recent Health of the NEM report suggests that investment in transmission and distribution networks is at an all-time low.¹ This is concerning given government and industry consensus is that more investment that is required to facilitate the energy transition.

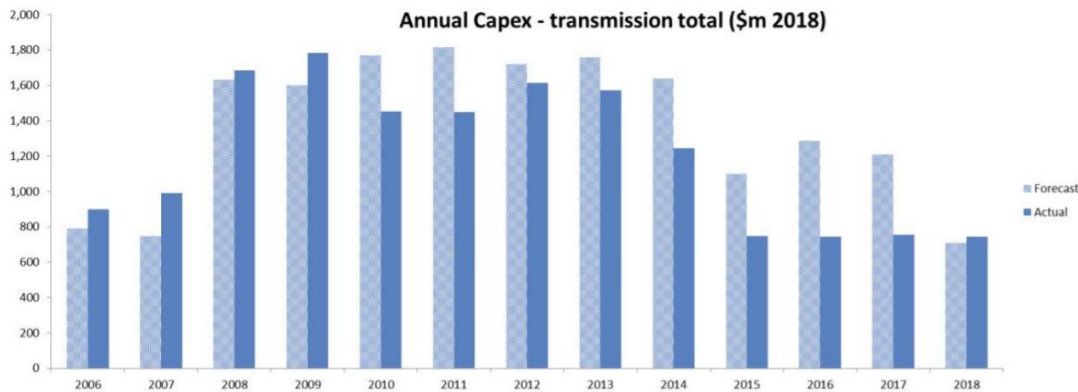


FIGURE 24: INVESTMENT IN TRANSMISSION

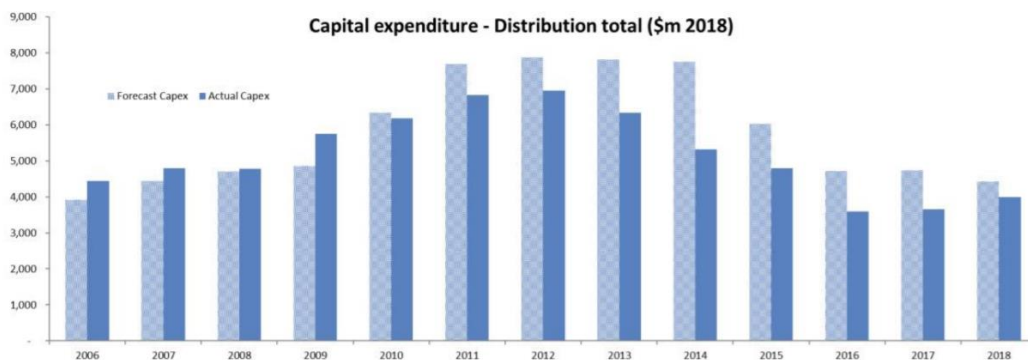


FIGURE 25: INVESTMENT IN DISTRIBUTION NETWORKS

In addition, the same report found that the security of supply remains at a critical rating, whilst reliability of the system has also deteriorated to a critical rating.² No conclusions are drawn in the report about the operation of the regulatory framework for electricity network regulation. However, these outcomes must be considered relevant when assessing the effectiveness of current regulatory settings.

We recommend several areas for further consideration, including incentives to deliver what customers value, recognition of the role of networks in price reductions and the financeability of major projects.

¹ Energy Security Board, The Health of the National Electricity Market, Volume 1: The ESB Health of the NEM Report, 2019, p. 38.

² Ibid, p. 8.

Incentives to deliver what customers value and the role of networks in price reductions

Throughout its recent planning processes, AEMO has consistently found that additional transmission and distribution investment would be beneficial for customers. For example:

- In 2018, AEMO identified that additional transmission investment would translate to approximately \$1.2 billion of savings.³
- In the same year, AEMO identified that a greater use of distributed energy resources could lower the total costs of supply, with the net present value of wholesale resource costs reduced by nearly \$4 billion.⁴
- The draft 2020 ISP identified that the ‘no regret’ transmission interconnector projects currently being progressed would deliver \$3.4 billion in benefits from lower fuel costs and deferral of generation capital costs.⁵

The work conducted by the Energy Security Board and market bodies to make the ISP actionable has improved planning and streamlined regulatory processes to facilitate the delivery of the benefits identified in the ISP. Nevertheless, we consider that there is still the potential for a disconnect between the optimal ‘development path’ identified by AEMO and the lowest cost outcome for consumers.

To help stakeholders and customers to understand the differences in costs between various options, we have recommended that AEMO be required to present the expected savings to electricity customers for each ISP development path, and where possible, for each Actionable ISP project.⁶ This will enable any expected changes in transmission charges due to additional investment to be compared against the total expected changes in a customer’s bill. Providing this information is consistent with the priorities of Federal and State Governments to reduce the overall cost of energy for end-consumers.

Risk has increased and is greater for large transmission projects

The risk allocation between networks and consumers is well established in the regulatory framework. As the AEMC points out, the current framework does not provide NSPs with a ‘guaranteed’ rate of return or a right to recover their actual costs. This means that the NSP wears most of the risk of overinvestment, even if the investment is subsequently considered efficient.

Where an NSP spends more than the forecast allowance (over-investment), it must:

- incur the cost of financing the overinvestment until it is rolled in to the regulated asset base;
- pay a 30% penalty on the over-investment; and
- be subject to an ex-post review by the AER of the efficiency of all other investment.

Where the ex-post review determines that any or all the NSPs investment is inefficient, consumers do not pay for that investment at all. This risk allocation currently incentivises NSPs to spend no more than the forecast allowance, even if the expenditure is efficient.

In normal circumstances, a network may be able to manage variations (over or under) within an overall allowance to avoid penalties. However, for a large transmission project, the variation, and probability of a variation occurring, is proportionately large and more difficult to manage within the expenditure allowance, making it more likely that a penalty will occur. This can also give rise to financing challenges given the profile of revenue provided under the regulatory framework, which defers the recovery of depreciation to later years.

³ Compared to the case where no new transmission is built to increase network capabilities between regions. AEMO, Integrated System Plan, July 2018, p. 6.

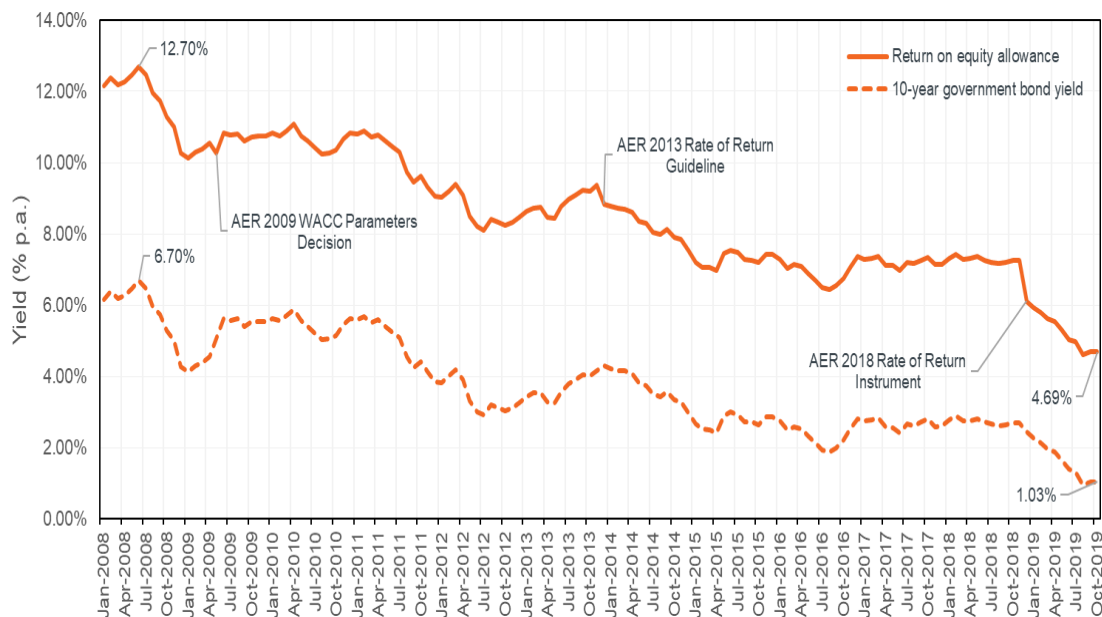
⁴ AEMO, Integrated System Plan, July 2018, p. 6.

⁵ AEMO, Draft 2020 Integrated System Plan, December 2019, p. 50.

⁶ This recommendation was made through the AER’s process for developing the Actionable ISP Guidelines.

Reward has reduced and does not support the financeability of large transmission projects

The strong incentives for NSPs to reduce expenditure compared to the forecast allowance has resulted in low levels of network investment within the NEM. This is further exacerbated by unprecedented low levels of regulated returns due to a reduction in the regulated equity risk premium, together with the significant falls in the risk-free rate. These low returns do not accord with market expectations and are likely to dampen investment because of the difficulty attracting capital at a cost consistent with the efficient cost of capital under the regulatory framework. The figure below illustrates the fall in equity returns and that it has outstripped the fall in the risk-free rate.



The growing divergence between the AER's forecast of expected inflation and market expectations of inflation has resulted in a further expected return on equity below the efficient cost of capital determined by the AER in the Rate of Return Instrument (**RORI**).⁷ The AER is currently undertaking a review of its approach to inflation which assumes that inflation will return to the mid-point of the RBA's target range after 2 years. This assumption has been materially different to market expectations for a number of years and has been made worse due to the COVID-19 economic crisis. A simple adjustment to the regulatory models could remove this unnecessary introduced risk and ensure NSPs have a reasonable opportunity to recover the efficient cost of capital.

Network investment in distribution networks was higher in 2019 than 2018 but lower for transmission network. However, AER determinations have applied significant reductions in equity returns for the period beyond 2020⁸ and capital expenditure forecasts that are 8% lower for DNSPs and 15% lower for TNSPs (excluding contingent projects).⁹ Given the combined effect of low returns and a strong incentive to spend no more than allowed revenue, low levels of investment can be expected to continue.

In many cases, low returns and increased risk have also created financeability issues.¹⁰ For large transmission projects, these issues are compounded by deferring the recovery of return of capital (depreciation) under the 'regulatory depreciation' approach which references a forecast RAB indexed by

⁷ See ENA presentation to the AER's Stakeholder Forum on the inflation review 2020, 2 July 2020.

⁸ The further reductions in equity returns in the RORI were applied in 2019 to the NSW DNSPs with a risk free rate of 2.04% to 2.14%; a significant reduction in risk free rate compared to the 2.7% indicative rate in the Explanatory Statement. The AER's decisions for South Australia and Queensland include a risk free rate, and therefore equity return, that is a further 100 basis points lower.

⁹ AER, State of the Energy Market 2020, June 2020, p. 139.

¹⁰ Where the revenue provided over a regulatory period or project is not sufficient for the NSP to maintain the credit rating assumed for the Benchmark Efficient Entity (**BEE**) with the expenditure forecast of the NSP.

the AER's forecast of inflation which is significantly higher than the expected indexation to apply at the end of the regulatory period. This also causes inter-generational inequity.

To ensure that these issues do not further exacerbate the low levels of network investment, the regulatory framework could provide for an adjustment to allow the amount of revenue recovered in any regulatory period, as well as the profile of revenue over the life of the investment, to be sufficient to achieve the assumed credit metrics. This 'financeability' assessment should be a required tool in the regulator's toolkit and is incorporated into the determinations of Ofgem and IPART. The AER has also acknowledged that reporting on credit metrics is relevant and it will have regard to this in reporting processes,¹¹ although this has not occurred to date.

Adopting regulatory best practice and instilling confidence in the independence of the regulator

Movements in risk, returns, capital investment and the Health of the NEM report are all relevant to the AEMC's review of the regulatory framework and whether it is delivering outcomes consistent with policy objectives and the long term interests of consumers. However, a further significant change since 2016 which has also impacted on the investment environment has been the removal of external review processes of the AER's determinations and judicial review of rate of return matters.

In 2015, the Vertigan Report highlighted the value of a review appeals regime to support investment:

"The separation of the rule making and rule enforcement functions, the independent regulatory authorities and the availability of a merits review appeals regime are key elements of the governance of the energy market which help establish credibility with investors and provide them with the confidence to invest in the sector."¹²

In 2016, the OECD undertook a review of the AER against the OECD Best Practice Principles for Regulatory Policy and considered that the ability to challenge the AER's decisions through the courts and/or competition tribunals was a key aspect of formal accountability. The OECD considered:¹³

"This is a cornerstone of accountability and helps to underpin acceptance of a regulator's independent status."

Australia is now an outlier in relation to governance arrangements. The OECD's Best Practice Principles for Regulatory Policy outlines regulated entities should have the right of appeal of decisions that have a significant impact on them, as well as the opportunity for independent review of significant regulatory decisions in the absence of strong public policy reasons to the contrary.¹⁴ Such a mechanism is also seen to improve the quality of the regulator's decision-making and internal review processes.¹⁵

We consider that investigating alternative accountability mechanisms should be considered if formal review mechanisms are not to be restored, to underpin incentives for the regulator to continually improve the effectiveness of consultation and decision processes and maintain stability and confidence in the process and decisions. The ability to seek review is a safety net, and, even if never used, can strengthen the authority of the regulator, underpin the legitimacy of consultation, and reinforce the better regulation toolkit.¹⁶

¹¹ AER, Objectives and priorities for reporting on regulated electricity and gas network performance, Final, June 2020, p. 12.

¹² Vertigan, Yarrow and Morton, Review of Governance Arrangements for Australian Energy Markets, Final Report, October 2015, p. 42

¹³ OECD, The Governance of Regulators' Practices: Accountability, Transparency and Co-ordination, The Governance of Regulators, 2016, p.57.

¹⁴ OECD, The Governance of Regulators, OECD Best Practice Principles for Regulatory Policy, 2014, p.80.

¹⁵ OECD, The Governance of Regulators, OECD Best Practice Principles for Regulatory Policy, 2014, p.85.

¹⁶ Luigi Carbone, Judge of the Supreme Administrative Court of Italy, and former Commissioner at the Italian Regulatory Authority for Electricity, Gas and Water, and Former Chair of the OECD Network of Economic Regulators (NER) Presentation to the ACCC/AER Regulatory Conference 2018, 26 July 2018.