

ELECTRICITY TRANSMISSION NETWORK owners forum

19 October 2006

John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
Australia Square, NSW 1215

By email: john.tamblyn@aemc.gov.au

Dear John,

Re: Commission's call of 12 October 2006 for further input on the draft Chapter 6 Rules

I refer to the posting on the Commission's website on 12 October 2006 inviting further submissions and comments by Friday 20 October 2006 from interested parties on several issues concerning the treatment of forecast capital and operating expenditure in the proposed Chapter 6 of the National Electricity Rules.

I write on behalf of the Electricity Transmission Network Owners' Forum (ETNOF) which, as you know, is comprised of Powerlink, TransGrid, SP AusNet, Transend and ElectraNet.

Significance for ETNOF of the issues raised

There is no other party more affected by the issues upon which you now seek input than ETNOF.

Together ETNOF's constituent members' businesses comprise the overwhelming majority of the businesses to which the new Chapter 6 would apply both by number and by business value. The value of assets engaged by these businesses in delivering services is approximately \$9.1bn.

ETNOF's constituent members are economically regulated businesses and Chapter 6 is the single most significant economic regulatory instrument applying to them. The Commission's review of Chapter 6 establishes a complete and exhaustive framework which determines the revenues that they are permitted to earn on their core businesses. Within Chapter 6, the treatment of capital and operating expenditure is a most significant issue that impacts on a TNSP's capacity to deliver reliable network services in accordance with its obligations.

The Commission's Draft Rule Determination also recognised that there is a:

"...crucial role played by the transmission network in facilitating competition and efficient resource use in the electricity wholesale and retail markets."



Participation to date by ETNOF in the consultation process

The new Chapter 6 rules currently being developed by the Commission are one of the key reforms adopted as part of a legislative package to reform the economic regulation of the electricity sector in Australia in the NEM States. Other key reforms included the establishment of the Commission itself and the establishment of a transparent, fair and efficient statutory rule making process which is set out in the National Electricity Law (NEL).

The new Chapter 6 Rules are to be made pursuant to the Division 3, Part 7 rule making process. Indeed, the development of the new Chapter 6 is the first significant exercise of the rule making process and it is thus the litmus test of that part of the reform package that implemented the rule change process.

The Commission has conducted its review in accordance with the legislated, transparent rule making process, and ETNOF and its members have participated in the whole of the review as set out below:

- The Commission's review process commenced with an initial Scoping Paper on 29 July 2005. In response ETNOF provided a four page submission on the appropriate objectives and scope of the new rules.
- The Commission's first Issues Paper recognised that the Commission's task was to establish a regulatory framework comprised of a whole package of interrelated elements which would together provide incentives for the efficient investment in and operation of transmission businesses. Key issues raised in the 104 page Issues Paper were the appropriate breadth of discretion for the regulator and consideration of the merits (or otherwise) of the 'propose respond' model and alternative procedural approaches via which the revenue cap decision could be determined by the regulator. ETNOF provided a 23 page considered submission in response to that paper.
- The Commission's formal process began with the issue of its section 95 Notice on 16 February 2006 accompanied by a Rule proposal and a report containing detailed reasoning of hundreds of pages. Sections 6.2.6 and 6.2.7 of the Rule proposal set out a framework in which the business would propose its operating and capital expenditure and the Regulator would be required to accept those estimates if the Regulator was satisfied that the estimates were reasonable. The Notice announced a section 98 public hearing and pursuant to section 97 invited submissions from interested parties by 20 March 2006. ETNOF attended and presented at the hearing and provided a 46 page written submission. ETNOF supported the over-all package of regulation presented in the Rule proposal but sought certain changes in the details.
- Outside the Commission process, the Ministerial Council on Energy had requested that an Expert Panel make certain recommendations with respect to energy network pricing. ETNOF participated in that review and the Expert Panel ultimately recommended a "fit for purpose" approach to regulation.
- As the next step in the process the Commission issued a further Notice and section 99 Draft Rule and again submissions were requested of participants, this time by 11 September 2006. Sections 6A.6.6 and 6A.6.7 of the Draft Rule retained a framework in which the business would propose its operating and capital expenditure and the Regulator would assess the reasonableness of the forecasts, and be obliged to accept the forecasts if satisfied that they are reasonable and certain other specified circumstances are present.

Amongst the developments that led from the Rule proposal to the Draft Rule was that the Commission took account of the Expert Panel's findings and stated that it considered the Draft Rule to comprise a "fit for purpose" model. ETNOF again made detailed submissions supporting the over-all package of the second Draft Rule and again seeking certain changes to the details of the package.

- No party requested the Commission to hold a hearing in relation to the Draft Rule.

In all of the above steps, ETNOF was mindful of the Commission's timeframe and deadlines and ETNOF worked hard to provide prompt input.

ETNOF was not the only participant. Many submissions were received at each stage of the process from a range of parties supportive of the approach in the Rule proposal and the Draft Rule that the AER must accept the TNSP's expenditure proposals if the AER is satisfied they are reasonable. A number of parties opposed that approach and, indeed, suggested alternative models such as a "best estimates" model. The Australian Government Solicitor's advice does not raise any issues that were not already previously raised by other parties and considered by the Commission.

The final step in the rule making process is the regulatory determination of the Commission through its publication pursuant to section 102 of a final Rule.

If it were not for the 12 October 2006 announcement by the Commission, the process would be a model application of the reformed rule making process. ETNOF considers that the process to date has been a thorough process which has identified all the relevant issues, tested propositions and reached outcomes based on careful analysis and broad consultation. The process led by the Commissioners has given ETNOF the confidence that they have heard all sides of the various debates on the issues which have arisen, applied their expertise and experience in analysing those issues and are now well placed to reach a best practice regulatory outcome.

Concerns with the 12 October 2006 web posting

The rule making process has been underway now for 15 months and, based on the above process, the key issues should now have been (and indeed would appear to have been) exposed to a complete examination. The key concepts have become settled through being reaffirmed several times during the process.

ETNOF members are relying on the Commission to adhere to the published deadline for its Final Determination with some members in advanced stages of preparation for their first regulatory cap decision processes to commence under the new Rules.

ETNOF is greatly concerned with the implications of the announcement by the Commission on 12 October 2006 for the content of the new Chapter 6 Rules and for the NEL rule making process itself. The Australian Government Solicitor's advice document received by the Commission comes almost exactly a month after the due date for submissions on the Draft Rule. It is not clear on whose behalf it is submitted to the Commission or what status the document (or the web-posting of it by the Commission) has in the rule making process.

As noted above, the AGS document raises no new issues that have not already been fully aired by the Commission even prior to the first Draft Rule as part of the Scoping Paper and Issues Paper processes.

On the other hand the document proposes a regulatory framework that is completely different to the Rule proposal and the Draft Rule that the Commission published during the consultation process undertaken by the Commission in respect of the new Chapter 6 Rules. No text is provided for that radically different draft rule and the only features of the draft rule identified are:

- that the AER would “determine whether the total [operational expenditure and capital expenditure forecasts] was the ‘best estimate’ that is reasonably possible in the circumstances”; and
- that the rule would not be a pure “propose-respond” model and rather be a limited propose-respond, limited consider-decide, or pure consider-decide model.

The Commission itself has gone to considerable lengths to explain that the Draft Rule sets out an integrated regulatory package. ETNOF agrees with this assessment. It is not clear what scope there is for this eleventh hour process to properly take account of the linkages between the process for approving capital and operational expenditures and the other provisions of the Draft Rules and it would be a totally inadequate substitute for the rule making process in the NEL for:

- such a fundamentally different proposed rule to be proposed without providing a draft text or any detailed description of its operation as section 99 requires; and
- only five full business days to be provided for consultation on a matter which concerns the essential capability of the ETNOF members to provide essential services. It is simply too late in the process for these issues to be seriously countenanced by the Commission.

ETNOF will provide what input it can within the timeframe

Given the constrained timeframe, ETNOF will do its best to participate in the consultation process now imposed upon it.

Although ETNOF considers that it is too late to effectively consult on a different rule proposal, it will endeavour to provide whatever comments it can by the stated due date so that the critically important final determination and commencement dates for the new Chapter 6 are not prejudiced.

For the purposes of putting together that input, ETNOF understands from the Commission’s 10 October 2006 web posting that:

1. ETNOF should address the three specific issues and the two particular questions posed on the Commission’s website.
2. Where the Commission refers to it being “aware that there has been some debate regarding the likely effect of the Draft Revenue Rules in so far as they deal with the treatment of forecast capital and operating expenditure” the points made in the debate and all associated material issues under consideration by the Commission are fully disclosed in submissions received by the Commission and published on its web site.
3. The alternative draft rule now under consideration under which “the AER [would] have a residual discretion to substitute its own reasonable estimate of forecast expenditure in those circumstances” would be that further detailed in the Australian Government Solicitor’s advice document and it would contain the following provisions:

- (a) The transmission business would initiate the revenue cap setting process by proposing forecast operational expenditures and forecast capital expenditures.
- (b) The AER would determine, and provide reasons:
 - (i) whether or not the proposed expenditures are “estimates arrived at on a reasonable basis” and if so,
 - (ii) whether or not the estimates are “best estimates”.
- (c) The basis for the AER’s determination(s) in (b), would be the application of criteria (1) to (4) listed in the Draft Rule at 6A.6.6(1) and 6A.6.7(1) taking the 12 items into account that are listed in 6A.6.6(2) and 6A.6.7(3).
- (d) If the AER determines in (b) above that:
 - (i) the estimates are not reasonable; or
 - (ii) the estimates although reasonable are not the “best estimates”,

then it must substitute its own “best estimates arrived at on a reasonable basis” again applying criteria (1) to (4) listed in the Draft Rule at 6A.6.6(1) and 6A.6.7(1) and taking into account the 12 items listed in 6A.6.6(2) and 6A.6.7(3).

Although not stated in the Solicitor’s advice document, the other elements of the proposal (from the contingent projects framework to the service incentives to the approach to depreciation) would appear to be those in the Commission’s Draft Rule and we will assume this to be the case. If our understanding above is incorrect, please let me know as soon as possible.

We will forward our necessarily limited substantive response as soon as possible.

Yours sincerely



Gordon Jardine
Chair of the Electricity Network Owners’ Forum

ELECTRICITY TRANSMISSION NETWORK owners

Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006

Response to AEMC Web Posting of 12 October 2006

20 October 2006



ETNOF Submission in Response to AEMC Web Posting of 12 October 2006

1 Introduction

The 10 October 2006 web posting states:

"The Commission is aware that there has been some debate regarding the likely effect of the Draft Revenue Rules in so far as they deal with the treatment of forecast capital and operating expenditure. In particular the Commission is aware that at least 3 questions have been raised by interested parties in relation to the draft wording of the revenue rules:

- (a) whether they impose an "onus of proof" on the TNSP or the AER;
- (b) whether it would be necessary for the AER to form a view that a TNSP's proposal was "unreasonable" before it could reject it; and
- (c) whether those rules would operate to create a presumption in favour of acceptance of the TNSP's proposed forecast expenditure, if the AER was satisfied that the proposal met the criteria contained in the revenue rules."

These issues were in part raised by the AER and in part by ETNOF. Their significance needs to be understood not just in respect of the specific provisions in clauses 6A.6.6(b) and 6A.6.7(b) but as part of the whole regulatory structure. This structure should be designed to provide incentives for TNSPs to manage their businesses as efficiently as possible and also provide a service which ensures the quality, reliability and security of supply which is sought in the Market Objective.

Sections 2 and 3 of this submission address that broader context as part of building a principled approach to addressing the following specific questions raised by the Commission as to:

"whether the Rules should provide that:

- (a) a TNSP's proposal must be accepted if the AER is satisfied that the proposal for forecast expenditure satisfies the criteria in the Rules; or
- (b) the AER should have a residual discretion to substitute its own reasonable estimate of forecast expenditure in those circumstances."

The answers to those questions are provided in Section 5 of this submission.

The key conclusion of that analysis is that the framework in the Commission's draft Rule for establishing the Opex and Capex allowances provides much stronger incentives for TNSPs to submit moderate, balanced and well substantiated proposals than does the "residual discretion" or "best estimates" model. The Commission's draft Rule also more strongly supports the accountability of TNSPs for service delivery. For both these reasons regulatory outcomes for energy users would be markedly superior if the approach in the Commission's draft Rule were to be maintained.

ETNOF notes that:

"It is the Commission's intention to obtain a legal opinion from a Senior Counsel in respect of these issues, which will be made publicly available at the time of the making and publication of the final rule determination and Rule to be made, which is scheduled for 26 October 2006."

While obtaining such advice is not of itself of concern, the comprehensive regulatory policy analysis below demonstrates that regulatory decision making needs to be based on *all* the relevant inputs and not solely on a legal analysis. Therefore, while such an advice can be a useful input for the Commission, it is not a substitute for a detailed consideration of all the policy issues by the Commission itself.

2 The AER's power to replace a TNSP's expenditure estimate must fit properly within a coherent entire regulatory framework

The NEM was designed to encourage electricity business to act commercially...

A key reform principle upon which the National Electricity Market was designed is that businesses should manage their own activities and operate commercially within the constraints of:

- competition where that is effective; and
- economic regulation that prevented the exercise of monopoly power where competition is lacking.

Transmission Network Service Providers are the commercial businesses responsible for:

- providing an adequate, reliable, safe and secure network service to network users and end customers; and
- doing so at an efficient price.

...and the regulator's role is to preventing monopoly charging.

The AER is responsible for ensuring that the businesses do not monopoly price.

The Australian Government Solicitor's advice includes statistics concerning the differences between the electricity distribution sector's expenditure proposals and expenditure levels approved by the various state regulators.

In the transmission sector¹, the statistics show that:

- on average the Opex requests by TNSPs are only 3% higher than the figures approved by the ACCC/AER; and
- on average the Capex requests by TNSPs are 12% higher than the figures approved by the ACCC/AER. It is important to note that the figure may be higher than it would otherwise appear because many of these application figures predate the adoption by the ACCC/AER of the contingent project mechanism.

However, more significant are figures that compare the ACCC/AER's judgement of the appropriate Opex and Capex figures with that which the businesses have actually spent during the regulatory period (or more accurately are projected by the end of the period to have spent). That data shows that the AER/ ACCC underestimated:

¹ These statistics include all ETNOF members and only ETNOF members. In all but one case the data concerns the current regulatory period. For one member it has not been possible in the time frame in which this submission has had to be provided to use the current regulatory period so the previous period has been used for that member.

- the required Opex spend by 5% on average; and
- the required Capex by 12% on average.

It is interesting that these figures are very close indeed to the corresponding figures above. The data shows that expenditure figures are very difficult to predict accurately and it appears that there are many factors influencing these numbers. However, the aggregate requests of all the TNSPs taken together are moderate (\$1.859bn for Opex and \$3.467bn for Capex) when compared with the aggregate amounts spent by TNSPs (\$1.887bn and \$3.398bn). The aggregate requests are also considerably closer to the actual aggregate expenditure figures than were those in the ACCC/AER decisions (\$1.802bn and \$3.038bn).

The next two sections of this submission explain why the Commission’s draft Rule is completely consistent with the above accountability framework but the “residual discretion” proposal is not.

3 Key features of the Commission’s draft Rule

The Commission’s draft Rule provides a rigorous and efficient regulatory discipline on TNSPs.

The Commission’s draft Rule provides for:

- (a) only reasonable expenditures to be included within the revenue cap determination which would be put together by identifying:
 - (i) those activities and investment projects that are reasonable to be undertaken; and
 - (ii) the reasonable costs of each of those activities and investments;
- (b) excessive expenditure proposals to be rejected;

An estimate developed by adopting an upward bias to each of the expenditure elements would be such an excessive expenditure proposal. Such an estimate developed with a systematic upward bias would not be reasonable and would be rejected. Rather, for the proposal to be accepted, the activities and projects proposed to be undertaken would need to be reasonable as well as their associated cost estimates.

- (c) the TNSP to develop proposed expenditure forecasts and assemble thorough supporting material including supporting data and analysis. This is important in order to:
 - (i) bring to the process the most accurate and detailed information available – which is, of course, information which only the TNSP can supply; and
 - (ii) promote accountability for the provision of an adequate, reliable and safe transmission service;
- (d) the AER to make a determination that a TNSP’s proposed activities,

investments and costs are reasonable or not. The primacy of the AER's decision is reinforced by a limited scope for review;

- (e) a structure which taken as a whole provides strong incentives for the TNSP's proposal to be balanced and well supported with detailed factual information analysis and assumptions. There are strong disincentives for ambit claims;
- (f) the concept that the business is permitted to recover its own reasonable estimates of expenditure. This concept mirrors the requirements of the NEL in that businesses be permitted a reasonable opportunity to recover their efficient costs; and
- (g) a whole regulatory package comprised of multiple interdependent elements including the above.

Importantly, the above regulatory model has been developed and thoroughly tested through a 15 month public process of detailed consultation and analysis.

Many of the above are self explanatory. However, further discussion is warranted of how the Commission's draft Rule:

- creates incentives for TNSPs to make efficient, balanced and well supported proposals not ambit ones (section 3.1); and
- promotes accountability for the TNSP for cost effective service delivery (section 3.2).

3.1 The incentive properties of the Commission's draft Rule proposal

The draft Rule has strong incentive properties for the business to propose efficient expenditure levels because...

The Commission's draft report stated that:

"[T]he Commission considers that the decision making process and criteria specified in the Proposed Rule and maintained in the Draft Rule for assessing expenditure forecasts provide the regulator with sufficient powers and safeguards to be able to achieve regulatory outcomes that are not overly distorted by strategic behaviour on the part of TNSPs."

Amongst the most powerful of the new safeguards introduced by the Commission is the notion that the TNSP's Boards of Directors must certify the proposal and how it has been established. This provides a strong incentive within the management of the company to investigate and verify the process for, and substance of, the proposals.

However other incentives in the draft Rule also exist which discourage TNSPs from "talking up" expenditure estimates in their proposals.

First, the draft Rule creates a strong incentive for TNSPs to propose an Opex and Capex forecast at, or as close as can reasonably be estimated, the efficient cost.

That may appear to be in contrast with the Australian Government Solicitor's analysis that:

“Even by taking into account the twelve factors suggested by the AEMC, the proposed Rule as currently drafted will mean that a range of totals are likely to be a reasonable estimate of expenditure. As the case law explains, given the inherent uncertainty of forecasting and factors which lead to divergent conclusions, a number of different totals may be seen as reasonable.”

It is important to put this quote in context and, in particular, the “range” referred to here is language from the GasNet decision. In that decision (which does refer to a range) and each of the other decisions referred to by the Australian Government Solicitor (which do not use the term “range”) it is clear that a reasonable estimate will often not be a unique forecast; *different minds, acting reasonably*, may reach different reasonable estimates.

However, a reasonable estimate must:

- identify reasonable activities and investment projects to be undertaken; and
- establish reasonable estimates of the costs of undertaking those activities and investment projects.

This is quite different from the Productivity Commission's concept of a “range of plausible estimates”. While the Productivity Commission's approach may be accurately described as permitting any figure within a range, it is an approach that was not adopted by the Expert Panel and it has never been part of the draft Chapter 6 rules proposed by the Commission.

More important than the legal characterisation of sections 6A.6.6 and 6A.6.7 of the draft Rule are the incentive properties of the package as a whole. This is a matter overlooked by the Australian Government Solicitor's advice.

...proposing a balanced, moderate forecast expenditure is safe for a TNSP and...

If a TNSP proposes a balanced, moderate estimate of Opex and Capex which is thoroughly substantiated with a reasonable suite of activities and investments each reasonably costed, it can be highly confident that its figure would be accepted by the AER. This avoids the risk of a necessarily more arbitrary review by the regulator and correspondingly a more uncertain environment for all parties concerned.

...there are also strong incentives for the TNSP to supply full information...

It is also important to recognise the incentives of the draft Rule for the business to reveal a comprehensive set of information. The draft Rule explicitly states that the AER is to take into account the material submitted by the TNSP in deciding whether or not the proposal is reasonable. If the TNSP withholds information or is sparing with the information it provides, that can be taken into account in determining that the proposal is not reasonable and is a basis upon which it passes to the AER to substitute its own estimates.

This is particularly important because, as the Expert Panel states:

“Regulated entities clearly are best placed to make operational decisions, and regulated entities are also best placed to understand the future expenditure needs of their business. Regulated entities also have access to detailed costs and commercial data not immediately available either to the regulator or to other stakeholders.”

...proposing an inflated estimate is risky for a TNSP.

On the other hand if a TNSP proposed unnecessary investments or activities or inflated the costs of these activities, there is a significant risk that the estimate would not be accepted by the AER as reasonable. Under the Commission’s draft Rule putting forward an inflated proposal in this way would be a very risky and uncomfortable approach for a TNSP to take because, if the AER is not satisfied that the TNSP’s estimates are reasonable, the AER may substitute its own reasonable estimates under Rule 6A.14.1(2)(ii) or (3)(ii). In doing so, the AER could itself select a reasonable estimate involving, perhaps, fewer or different activities or investments or lower cost figures for the TNSP. In the ordinary course, with very limited scope for review, the AER decision would prevail even if the estimate is a low one and does not provide for activities which the TNSP considers to be, and the AER determines are, reasonable.

Although the AER would be required to explain why its substituted expenditure allowances are reasonable, it is not required to reconcile the differences between its “reasonable estimate” and the original proposal submitted by the TNSP. This is quite different from other parts of the draft Rules such as Rule 6A.15(c)² which applies when the AER is called upon to correct a material error in a revenue cap and illustrates the significance of this point.

The figures presented in Section 2 of this submission demonstrate that there is a very real risk that the AER could select an estimate well below a TNSP’s actual costs.

3.2 Promoting accountability for service provision

The reliability of electricity transmission networks is critical for the community as a whole...

The Expert Panel stated under the heading “truncated returns and asymmetric risk” that:

“The Panel is strongly aware of the increasingly integrated and interdependent nature of the economy and its dependence on safe and reliable energy supply. It notes that the costs of transmission and distribution failures (particular in electricity) are high because of the much more pervasive impacts.”

Indeed, the costs to the community as a whole of such failures (economic or otherwise) can be extremely high as demonstrated by the reports published after:

- the US-Canada Power System outage;

² This section states: “If the AER revokes a *revenue cap determination* [for material error], the substituted *revenue cap determination* must only vary from the revoked *revenue cap determination* to the extent necessary to correct the relevant error.”

- the Auckland transmission outage; and
- the Esso-BHP outage.

Such outages impact on the productivity of almost every industry as well as the amenity of end consumers.

...but the community also suffers when costs and prices are excessive.

Of course regulatory errors also occur in the other direction – where businesses are permitted to make unnecessary investments, incur inefficient costs or, perhaps more outrageously, charge customers without making appropriate expenditures. ETNOF agrees that these regulatory failures should also be avoided but notes that they are generally unlikely to be as costly as failures in which service is significantly interrupted.

The Commission needs to take account of the effects of the expenditure approval framework on service delivery outcomes.

While Chapter 6 focuses on identifying efficient costs and revenues, it is important not to lose sight of the central obligations of a TNSP – that it supply an adequate, reliable, safe and secure network service to network users and end customers.

TNSPs can only be held accountable for providing an adequate, reliable, safe and secure network service to network users and end customers if they are also empowered to plan and identify what infrastructure and operational activities are required and to identify the reasonable costs of these activities.

If the TNSP has proposed the expenditure forecasts there is no excuse for poor service.

If, consistent with the draft Rule, the TNSP has proposed forecasts of Opex and Capex which are accepted by the AER it can be held accountable, without excuses, for the whole package of service and price.

Without being responsible for expenditure estimates, TNSPs cannot be held responsible for service outcomes.

History has demonstrated the potentially disastrous consequences of disempowering network businesses in that:

- the expenditure can be inadequate to sustain the required level of service and where service levels fall, the responsibility rightly rests with the regulator;
- it can put improper pressures on essential expenditures to maintain assets and safety; or
- managers in network businesses can be left in an impossible position squeezed between service and safety requirements that are unrealistic compared with the funds available.

4 Key features of the “residual discretion” or “best estimate” model

There are significant deficiencies associated with the

By contrast with the above, the “residual discretion” or “best estimate” model proposed in the Australian Government Solicitor’s advice:

“residual discretion” / “best estimates” model

- (a) does not provide incentives for the TNSP to present a moderate, balanced proposal;
- (b) has weak incentives to provide fulsome information;
- (c) does not have the same accountability properties because, while the regulatory structure imposes reliability and security obligations on the TNSP, there may be inadequate funds to maintain reliability and security where the AER has substituted its own estimate and it would be unclear to what extent the AER or the TNSP was the party responsible for the consequences;
- (d) is missing key details of the framework and in particular, what makes an estimate the “best” estimate?

The Commission itself has already recognised the deficiencies of striving for a “best estimate”:

“Any attempt to identify the ‘best’ estimate in these circumstances [ie the circumstances facing the typical TNSP] is unachievable and involves the risk of regulatory error.”

Key reasons why the Commission’s conclusion is valid are reiterated below.

Further, the AGS advice is an early step in the distribution rule process, a process that has not yet undergone consultation.

The Australian Government Solicitor’s advice is provided to the Commonwealth in the context of it taking a:

“...position regarding the drafting of electricity distribution revenue rules...”.

The process for determining the distribution rules is at a far earlier stage. The SCO has not yet commenced its consultation process on the distribution rules and the above issues (and potentially many others) have yet to be raised, tested or addressed. It would be quite perverse for such an untested and early product of the distribution rule making process to be adopted in the transmission rule making process in preference for the models which have been developed, discussed and tested in that transmission process.

4.1 Incentive properties

The alternative “residual discretion” model destroys the incentive properties of the draft Rule.

Under the “residual discretion” or “best estimates” model, even if the TNSP proposed a moderate, well balanced and thoroughly substantiated proposal, the AER could use its “residual discretion” to replace that figure with its own “best estimate”. With no incumbency at all for the TNSP’s initial proposal, and with a high degree of uncertainty as to whether its proposal will be accepted, it is difficult to identify any incentive for the initial proposal:

- to be moderate or well balanced; or

- for effort to be put into it being fully substantiated.

If the AER had as good knowledge of, and responsibility for, operating an electricity network business as the business itself does, the “residual discretion” model might be able to produce a result that is as good as the result produced by the incentive properties of the draft Rule. However, that is not the case. The information available to the AER and its experience in running a network businesses will necessarily fall well short of the information and experience of the TNSP itself.

Further, if the AER is empowered to replace the estimates proposed by a TNSP which had been certified by its Board of Directors with the AER’s own estimate, who would certify the process and substance of that replacement estimate to ensure that it was prepared with a comparable degree of rigor and scrutiny?

Seeking the “best estimate” would actually amount to a sorry “second best” outcome.

Therefore, a framework such as the draft Rule under which the party with the best knowledge and experience is provided with incentives to propose Opex and Capex estimates well within the acceptable legal range must be superior to a framework in which a party with indirect knowledge and no experience in running a business attempts to make a “best estimate” of those figures. In fact, the “residual discretion” model would necessarily elevate in the decision making hierarchy a sorry “second best” decision above the informed decision of the business itself.

4.2 Accountability for service delivery

The “residual discretion” / “best estimate” model undermines accountability for service outcomes.

Under the “residual discretion” or “best estimates” approach:

- the TNSP would have responsibility for service quality; but
- the AER would be the author of the costs estimates (including what activities and investment projects are deemed to be those applicable to a “best estimate”).

Say the AER rejected a TNSP’s proposal that the AER had determined was not reasonable because it considered it would be “better” to undertake different activities or investments from those proposed by the TNSP:

- Should the TNSP then change its planned expenditures and replace them with the expenditures of the AER?
- If those activities or investments proved to be inadequate, would the TNSP be relieved of its obligations in respect of service delivery?
- If the TNSP is relieved of its obligations with respect to service delivery and a customer suffers losses, it would not be clear how accountability should be shared between the TNSP and the AER and in what way?

Say the AER rejected a TNSP’s proposal that the AER had determined was not reasonable because it considered an activity could be done more cheaply and the activities or investments could only be undertaken to a lower level or not

undertaken at all.

- Would the TNSP be relieved of its obligations in respect of service delivery?
- If the TNSP is relieved of its obligations with respect to service delivery and a customer suffers losses, it would not be clear how accountability should be shared between the TNSP and the AER and in what way

These questions would undermine outcomes on issues that are central to a TNSP's obligations which are taken very seriously and are fully considered in preparing their revenue proposals.

They are also questions that the Australian Government Solicitor's advice has not addressed.

4.3 Other important linkages

The model in the Australian Government Solicitor's advice also fails to identify a range of linkages between the Opex and Capex approval framework and other rules.

It is also the case that other elements of the Chapter 6 Draft Rule package are intertwined with the approach on the Opex and Capex forecasts. For example, the less able the general Capex forecast is to be flexible to changed circumstances the greater the role for the contingent projects regime and revenue cap reopening provisions.

If the Commission were to change the Capex proposal approval process in the manner contemplated by the Australian Government Solicitor's advice then it would be necessary to reconsider lowering the threshold in the contingent projects regime. If the proposed changes to the Opex proposal approval process were made, it would be necessary to revisit whether additional triggers should be inserted in the re-opener provisions and whether the value of the threshold should be substantially reduced.

Many other consequential changes may be needed.

5 Answers to specific questions

The Commission has asked interested parties whether the Rules should provide that:

- (a) a TNSP's proposal must be accepted if the AER is satisfied that the proposal for forecast expenditure satisfies the criteria in the Rules; or
- (b) the AER should have a residual discretion to substitute its own reasonable estimate of forecast expenditure in those circumstances.

As detailed above, there are strong reasons why (a) should be preferred over (b) including:

- option (a) is likely to produce expenditure outcomes that are:
 - moderate and well balanced; and
 - thoroughly substantiated;
- option (a) reinforces TNSP accountability for service delivery levels;

- option (b) creates regulatory uncertainty and provides poor incentive properties for TNSPs to:
 - temper expenditure proposals; and
 - provide a fulsome exposition of the information at their disposal; and
- option (b) significantly undermines and confuses accountability for service delivery.

It is important for the Commission not to be diverted from completing its well considered “fit for purpose” approach to electricity transmission regulation in response to receiving a preliminary part of the distribution rule making process that has yet to even commence consultation.

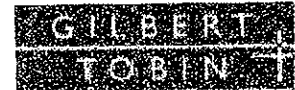
ETNOF continues to strongly support the core concepts of the Commission’s draft Rule, with the amendments proposed in its previous submissions, which have been developed through the Commission’s rigorous and extensive consultation process.

In particular, ETNOF strongly supports the structure in the draft Rule under which the business is responsible for proposing a measured, balanced and well substantiated expenditure proposal, and is provided with incentives to do so.

Importantly, the AER’s assessment of the reasonableness of those estimated Opex and Capex expenditures, and where they are not reasonable the substitution by the AER’s own estimates, commands primacy in the regulatory structure.

After the 15 months already spent carefully investigating issues, developing the new Chapter 6 and testing its provisions, it is also imperative that the process is now concluded swiftly and within the Commission’s current timetable. In particular, several of the TNSP businesses that are to be subject to these rules are in the advanced stages of preparing for their first regulatory reviews under the new regulatory regime.

Partner Luke Woodward
 Contact Nick Taylor
 T +61 2 9263 4255
 ntaylor@gtlaw.com.au
 Our ref LXW:NJT:0252089



LAWYERS

20 October 2006

By mail

Dr John Tamblyn
 Chairman
 Australian Energy Market Commission
 PO Box H166
 Australia Square NSW 1215

Gilbert + Tobin

2 Park Street
 Sydney NSW 2000
 Australia

GPO Box 3810
 Sydney NSW 2001

T +61 2 9263 4000
 F +61 2 9263 4111

DX 10348 SSE

www.gtlaw.com.au

Dear Dr Tamblyn

Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006: Response to the Australian Government Solicitor Advice to the Department of Industry, Tourism and Resources

Following the publication by the Australian Energy Market Commission (AEMC) of the Draft Determination and second Draft Rule (National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006) on 26 July 2006, and the close of submissions on the Draft Determination and Draft Rule on 11 September 2006, the AEMC posted on its website advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources regarding the assessment of expenditure forecasts under the Draft Rule.

The AEMC has sought further submissions and comments from interested parties in relation to a number of matters covered by the advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources (the AGS Advice) by 20 October 2006.

We have been requested by the Electricity Transmission Network Owners' Forum (ETNOF) to review and comment upon the AGS Advice. Please see our response to a number of key issues raised by the AGS Advice below.

Would the Draft Rules require the AER to make a decision as to whether the TNSPs forecast operating and capital expenditure are reasonable estimates?

In relation to the role of the AER in assessing whether the estimates of the total forecast capital and operating expenditure are reasonable, the AGS Advice concludes that "the key task of the AER is to assess whether the proposed total is a reasonable estimate or is not a reasonable estimate"¹.

We agree that the intent of the Draft Rules, as reflected in the provisions of the Draft Rules referred to in the AGS Advice², is to require the AER to determine whether the estimate of the forecast capital and operating expenditure is a reasonable estimate or is not a reasonable estimate. However, and as discussed in detail in our letter to the Chairman of the Australian Energy Market Commission dated 11 September 2006, under Draft Rules 6A.6.6 and 6A.6.7, the AER is not actually required to make a determination as to whether the estimates provided are reasonable or not. Our advice noted that while a determination of the issue of reasonableness is a pre-condition for the acceptance of the estimates, there is actually no requirement for the AER to make a determination on this matter. While

¹ Advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources, 10 October 2006, p 2

² Rule 6A.14, 6A.12.1(b), 6A.13.1(b), 6A.14.1(2) and (3).



LAWYERS

Draft Rule 6A.14.1 clearly envisages that the decision will contain either a positive or negative determination by the Commission as to whether the estimates submitted by the TNSPs are reasonable, no provision of the Draft Rules directly and explicitly requires the AER to make this determination.

The drafting issues raised by us in our September letter on this point are not considered in the AGS Advice and it does not appear that the authors of the AGS Advice were directed to the issues in our September 2006 letter.

Importantly, the 11 September 2006 letter noted that with minor and relatively straightforward revisions to Draft Rules 6A.6.6 and 6A.6.7 (which provisions are not directly considered in the AGS Advice), and consequential amendments to Draft Rules 6A.13 and 6A.14, the Draft Rule would more accurately reflect the framework intended by the AEMC, upon which there is general consensus as to its form. We again emphasise here the need for these revisions to ensure the final Rules capture the intent of the Draft Rules – that is, that the TNSPs propose reasonable estimates of forecast expenditure for assessment by the AER and the AER's primary task is to assess those estimates and to exercise its regulatory judgment as to the reasonableness or otherwise of those estimates.

What is the nature of the discretion of the AER to reject what it considers to be an unreasonable estimate?

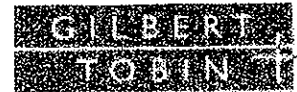
The tenor of the authorities and reasoning in the AGS Advice in relation to the power of the AER to reject what it considers to be an unreasonable estimate is in substance that the AER is in a strong position to exercise its own judgment to determine whether an estimate put forward by a TNSP is reasonable. This is consistent with our views set out in our September letter.

In particular, having regard to the cases referred to in the AGS Advice, including *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6, *ACCC v Australian Competition Tribunal* [2006] FCAFC 83, and *Telstra Corporation Limited* [2006] ACompT4, it is clear that in analogous regulatory settings, where it is the role of the regulator to determine whether a particular thing is reasonable or consistent with specified statutory criteria, the regulator has the primary role in exercising its judgement as to whether it is satisfied the estimates are reasonable in making its determination. What the regulator is unable to do in these analogous regulatory settings is, if it considers that the particular thing is reasonable or consistent with specified statutory criteria, reject it on the basis that the regulator prefers a different outcome, perhaps because in its view it considers that its preferred outcome is "better" than the one put forward by the regulated entity.³

In respect of judicial review, a determination by the AER that an estimate was or was not a reasonable estimate would be unlikely to be overturned on appeal. This is consistent with our letter of 11 September 2006 that noted:

"The MCE proposal for merits review³ of AER pricing and revenue determinations for transmission gives fundamental primacy to the regulatory judgment of the AER. AER decisions will only be subject to merits review on the following grounds:

³ See in particular *Telstra Corporation Limited* [2006] ACompT 4, [63] where the Australian Competition Tribunal noted: "In considering whether Telstra's estimates of its costs are reasonable we are not driven to considering whether the Commission's or other parties' views or assessment of those costs are more reasonable. Nor do we enquire whether Telstra's method or approach in estimating its costs is the correct or appropriate approach. If Telstra's method or approach in estimating its costs is reasonable having regard to the statutory matters set out in ss 152AH and 152AB then the matter rests and a comparison with the \$9.00 monthly charge is then to be made...".



LAWYERS

- that the decision maker made an error of fact and that fact was material to the decision;
- that the exercise of the decision maker's discretion was incorrect having regard to all the circumstances; or
- that the decision maker's decision was unreasonable having regard to all the circumstances.

Clearly the exercise of regulatory judgement does not constitute a factual error and is not reviewable.⁴

Nor does the concept of reasonableness permit second guessing of regulatory judgment.

³ *Review of Decision-Making in the Gas and Electricity Regulatory Frameworks, Decision*, Ministerial Council on Energy, May 2006.

⁴ See *TXU Electricity Ltd v Office of the Regulator-General* [2001] VSC 163 at [312-7]; see also the decisions of the Victorian Appeal Panel dated 17 February 2006 in appeals by United Energy Distribution Pty Ltd and Powercor Australia Ltd against determinations of the Essential Services Commission."

The 12 matters that the AER is required to take into account in determining whether an estimate of forecast operating and capital expenditure is reasonable provide significant safeguards that ensure where an estimate has been derived in a manner that is unreasonable, the AER is able to confidently exercise its own independent judgement as to whether the estimate is reasonable or not reasonable. As the AGS Advice notes, the "AER is required to assess the probity and veracity of all the evidence presented and may discount weakly supported arguments or assertions"⁴. The AER is also required to take into account submissions received in the course of consulting on the revenue proposal, as well as analysis that has been undertaken for the AER by experts.⁵

For example, where a TNSP uses a means to derive the estimate that is unreasonable – for example, and having regard to the concerns that a TNSP may simply adopt estimates consistently at the upper end of a reasonable range, if a TNSP was biased to high range estimates in its selection of the parameters it used in generating its estimates, the AER would again, safely be able to exercise its own judgement to determine that the estimate put forward by the TNSP was not reasonable. See *Application by Epic Energy South Australia Pty Ltd* (2004) ATPR 41-977, where the selection by the ACCC of the lowest price for pipe from a range, contrary to expert opinion that a mean or median figure was appropriate and without a rigorous and systematic evaluation process, was held to be unreasonable.

Would the Draft Rules require the AER to determine a range of totals, within which the AER would be required to accept an estimate?

In response to the question asked by the Department of Industry, Tourism and Resources as to whether there will be a range of totals that the AER must accept under the AEMC Rule, the AGS Advice concludes that the AER would have to determine such a range, and if the estimate fell within this range, the AER would be required to accept this estimate.⁶ The AGS conclude that the AER must accept a range of totals, and implies the risk that the TNSP will select a figure at the upper end of the

⁴ Advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources, 10 October 2006, p 2.

⁵ These factors are noted in the Advice: see Advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources, 10 October 2006, p 17.

⁶ Advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources, 10 October 2006, p 2



LAWYERS

range, which must be then accepted by the AER. However, the AGS Advice does not consider the Epic South Australia decision, noted above, in which the selection of a estimate at the outer edge of a range was held to be unreasonable.

More fundamentally, we do not agree (if it is the implication of the AGS Advice) that the Draft Rules require the consideration of a range and then determination of whether the estimate is within that range. This is not what is provided for in the Draft Rules and it is confusing and unhelpful to characterise the task of the AER under the Rules as first determining a range and then determining whether the estimate put forward by the TNSP fell within this range.

Put simply (and assuming the revisions suggested in our letter of 11 September 2006 are adopted to reflect the intent of the Draft Rules), the Draft Rules require the following:

- TNSPs to propose reasonable estimates of forecast expenditure for assessment by the AER;
- the AER has the primary task of assessing those estimates and exercising its regulatory judgment as to their reasonableness or otherwise;
- the criteria and the matters the AER must take into account are well specified and the prospect of arbitrary decisions is removed; and
- if the estimates are not, in the AER's opinion, reasonable, the AER can determine its own estimates against specified criteria, having regard to a specified set of matters.

The AER is not required to determine a range of totals. Its responsibility is to determine the reasonableness of the estimate. The process for determining the reasonableness of the estimate is, in an analogous regulatory context, set out in the case of *Telstra Corporation Limited* [2006] ACompT 4, which is quoted in the AGS Advice.⁷

"...in coming to a decision whether or not a term relating to a price or charge is reasonable it is necessary for the Tribunal to look at the means by which the price or charge was derived and to consider whether the method adopted was, in the circumstances, reasonable."

Again, assuming the revisions suggested in our letter of 11 September 2006 were adopted, the Draft Rules require the AER to make a determination as to whether the estimates put forward by the TNSP are reasonable and the AER is required to make this determination taking into account specified criteria and matters. This does not involve the determination of a "range" of reasonable estimates – it merely requires a judgment as to whether the means by which the estimate has been derived are reasonable and, therefore, whether the total estimate is reasonable.

⁷ Ibid, pp 10 – 12.



LAWYERS

Issues arising from a formulation that required the AER to determine whether the estimate put forward by the TNSP was the 'best estimate'

The Department of Industry, Tourism and Resources asked the Australian Government Solicitor whether:

"...a formulation that required the AER to determine whether the total was the 'best estimate that is reasonably possible in the circumstances' result in the [sic] greater discretion for the regulator to reject proposals that it considers to be inefficiently high?"⁸

As a threshold issue we note that a "best estimate" model that would involve the AER determining whether the TNSP's estimate was the "best estimate" and, if not, rejecting that estimate and substituting an estimate that the AER considered to be the "best estimate", has not been the subject of consultation and, as such, has not been exposed to scrutiny and testing by interested parties. The AGS Advice does not point to any other regulatory contexts, either in Australia or overseas, where a "best estimates" model has been adopted and is currently in operation. Nor has the Department specified how this model may work. We don't mean to be critical of the Department or the AGS, as we understand that the Department is in the early stages of considering this model in another regulatory context. The point is simply, at this time, there is little clarity as to what this approach would entail.

For our part, we find the concept of a best estimate somewhat elusive. The estimate submitted by the TNSP should be its best estimate of forecast operational and capital expenditure. In providing its estimate, it presumably is exercising judgement as to the range of activities it expects to undertake and the likely cost of such activities. TNSPs direct significant management time to the development of forecasts for operating and capital expenditure and it would be illogical to suggest that through this process the TNSP is not driven to produce its "best estimate". Submission of an estimate would carry with it the implication that it is the TNSP's best estimate. The AER would certainly be entitled to ask the TNSP whether it did reflect its best estimate. So much can be accepted as already inherent in the current regime.

The central difficulty with what appears to be proposed is the proposal that a "best estimate" test would "give the AER discretion to substitute a better total when it is not satisfied with that proposed by a service provider".⁹ This raises the question of what constitutes a better estimate. Ultimately, this is an evaluative judgement, where the "better total" is what the AER considers to be a better estimate – it does not necessarily follow that the "better estimate" is in fact better. Such an approach fundamentally undermines the current Draft Rule approach and the policy thinking behind it. Either the process is completely subjective, where notwithstanding a finding that the estimate of the TNSP is reasonable, the AER can reject it because it considers its estimate to be better (that is the best) or would require the formulation of objective and detailed criteria as to what makes one reasonable estimate better than another reasonable estimate.

In practice, where the AER had derived its own estimates which differ from those of the TNSP, it is likely that it would consider its own estimates to be better notwithstanding that it may accept that the TNSPs estimates are reasonable.

Consistent with the case law reviewed in the AGS Advice, regulatory exercises such as the estimation of costs are not capable of precision producing the one right or best answer.¹⁰ Where the AER

⁸ Ibid, p 3.

⁹ Advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources, 10 October 2006, p 3.

¹⁰ See the GasNet decision quoted on page 9 of the Advice which relevantly states: "Different minds, acting reasonably, can be expected to make different choices within a range of possible choices which nonetheless remain consistent with the Reference



LAWYERS

determines that a value put forward by a TNSP is reasonable, but it is not the same as the AER's preferred value, this value preferred by the AER is not "better" or "worse" than the TNSPs – it is simply different. Of course if the AER finds the TNSP's estimate not to be reasonable, then it can reject it and adopt its own.

Given that the estimate put forward by the TNSP will in fact be its best estimate, in our view, the current Draft Rule is in fact already consistent with the concepts set out at page 22 of the AGS Advice, interpreting the Expert Panel's views of a "best estimate" model that:

"...the AER must accept a forecast if it is satisfied that the total:

- is the best estimate that is reasonably possible in the circumstances; and
- is arrived at on a reasonable basis;

having regard to the factors in the proposed Rule."¹¹

However, to move beyond the current Draft Rule and permit the AER to reject an estimate which it finds to be reasonable because it considers its estimate to be better, raises a number of unanswered questions, including:

- what criteria would the AER use to determine when one reasonable estimate is better than another?
- would the AER have to substantiate that its estimate was better?
- if the AER's estimate was based on a different assessment of the activities required to maintain a safe and reliable system, who would be accountable for safety and reliability? Would it be the AER or the TNSP?
- in the case of review, would the responsible review body have to decide whether the estimate of the TNSP or the AER was the best estimate, and how would it do this?

The Advice notes that the "best estimate" model "will result in more symmetrical review rights for users and service providers as opposed to a test based on a reasonable estimate"¹². We do not understand, and the Advice does not explain, why this would be the case. Review cases that are based on a requirement to demonstrate that one estimate is better than another will simply result in economists "at 10 paces". As discussed above, case law has established that these issues are not capable of exactitude – matters of judgment are involved, and that is the case whether it is the TNSP, the AER or the review body attempting to derive an estimate of forecast operating and capital expenditure.

Conclusion

In our opinion, the AGS Advice does not demonstrate that the current Draft Rule framework is an inappropriate framework on the part of the AEMC. Ultimately, this is a policy decision of the AEMC,

Tariff Principles" and the Telstra case quoted on page 11 of the Advice which relevantly notes: "In this area of analysis there is no one correct or appropriate figure in determining reasonable costs or a reasonable charge. Matters and issues of judgment and degree are involved at various levels of the analysis".

¹¹ Advice from the Australian Government Solicitor to the Department of Industry, Tourism and Resources, 10 October 2006, p 22.

¹² Ibid. p 22.



LAWYERS

not a legal issue. The AGS Advice, in our view, demonstrates no legal failings in the AEMC fit for purpose framework.

Further, in our view, a best estimates model requires significantly more development and testing before it is capable of sensible assessment.

Yours sincerely

A handwritten signature in black ink, appearing to read "Luke Woodward", written over a horizontal line.

Luke Woodward
Partner
T +61 2 9263 4014
lwoodward@gtlaw.com.au

A handwritten signature in black ink, appearing to read "Nick Taylor", written in a cursive style.

Nick Taylor
Partner
T +61 2 9263 4255
ntaylor@gtlaw.com.au