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Mr John Pierce
Chair
Australian Energy Market Commission
PO Box A2449
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Dear Mr Pierce,

ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS

I am pleased to make this submission in response to the Australian Energy Market Commission's (AEMC) Consultation Paper, Consolidated Rule Request - Economic Regulation of Network Service Providers, published on 3 November 2011.

Any queries in relation to this submission should be directed to Mark Feather, Acting Executive Director, Energy Sector Development, Department of Primary Industries by email at mark.feather@dpi.vic.gov.au or by phone on 03 9658 4793.

Yours faithfully,

HON. MICHAEL O'BRIEN MP
Minister for Energy and Resources

8 / 12 / 2011

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SUBMISSION TO THE AEMC'S CONSULTATION PAPER (ERC0134) – Consolidated Rule Request - National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011

The Victorian Government is committed to ensuring that all Victorians can access energy that is affordable, reliable and more sustainable.

Accordingly, I welcome the opportunity to make a submission to the Australian Energy Market Commission's (AEMC) rule change processes on the economic regulation of electricity and gas network businesses following receipt of rule change requests from the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC).

Background

Victoria has led the privatisation and reform of the electricity and gas sectors in response to the Hilmer review in the mid 1990s. It has supported the more recent reforms to the economic regulation of the monopoly network businesses, with the transfer of the responsibility for economic regulation from a state-based regime to a national regime.

Prior to the transfer to the national regime, Victoria had an economic regulatory regime that was outcomes-based¹, consistent with good regulatory practice as set out in the Victorian Government's Guide to Regulation²:

... because of its inflexibility, prescriptive regulation is unsuitable in situations where circumstances are subject to change (e.g. due to technological change). Moreover, prescriptive rules often do not provide incentives for the intended outcomes of regulation to be achieved at least cost.

... where appropriate and where permitted by the enabling legislation – prescriptive rules should be avoided, and consideration should instead be given to the use of:

- *Performance-based standards (or principle-based regulation in cases where it is not feasible to set objective performance-based standards); and/or*
- *Process-based regulation, where there are substantial risks that need to be managed simultaneously.*

In contrast, the current national economic regulatory regime is far more prescriptive. In developing the National Electricity Rules (NER) and National Gas Rules (NGR), the pendulum between an outcomes-based regime and a prescriptive regime swung away from an outcomes-based approach to a prescriptive approach, largely in response to concerns from businesses that the existing regime provided insufficient investment certainty.

¹ An outcomes-based regulatory regime is one in which the outcomes or objectives are specified, but not the means by which these outcomes have to be met.

² Victorian Government, Victorian Guide to Regulation, April 2007, page 3-8

The current balance between an outcomes-based regime and a prescriptive regime in the NER and NGR was largely determined as part of a review of the economic regulation of electricity transmission businesses that was undertaken by the AEMC in 2006. At that time, the AEMC stated that³:

The Commission's Review has been guided by the NEM objective of promoting an efficient, reliable and safe electricity system. Its goal has been to design a regulatory regime that will facilitate efficient investment in and operation of transmission services, thereby promoting competition and efficiency in the electricity wholesale and retail markets and the long-term interests of consumers of electricity. It has also sought to improve the environment for investment by increasing regulatory clarity and certainty through the Rules.

The Revenue Rules provide a balanced regulatory framework with appropriate incentives for efficient network investment and operation. The framework is designed to manage the potential for the exercise of market power by network operators while maintaining effective regulation with an appropriate requirement for clarity, transparency and accountability on the part of the regulator.

Similarly, the AER has indicated that its proposal⁴:

... seeks to achieve a balance between the interests of consumers and [businesses] which aligns with the revenue and pricing principles.

The objectives for determining the appropriate balance between an outcomes-based regime and a prescriptive-based regime are still valid. A swing back towards a more outcomes-based regime will achieve a better balance between the interests of consumers and the businesses as sought by the AEMC in 2006.

Consistent with this philosophy, this submission supports proposed rule changes that result in a more outcomes-based regime. Notwithstanding this overarching approach, this submission considers each area in which rule changes are proposed:

- The framework for determining an efficient and prudent level of forecast capital expenditure (capex) and operating expenditure (opex), in particular a proposed incentive mechanism for capex, the use of forecast or actual depreciation and the exclusion of related party margins from the regulatory asset base (RAB)
- The determination of the rate of return
- The regulatory decision-making process

3 AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006, page iv

4 AER, *Economic regulation of transmission and distribution network service providers, AER's proposed changes to the National Electricity Rules*, September 2011, page 63

Capex and opex framework

The AER has proposed rule changes that relate to:

- Setting estimates of required expenditure
- Expenditure objectives, factors and criteria
- Capex incentives
- Use of actual or forecast depreciation
- Contingent projects, capex reopeners and pass through events
- Excluding related party margins and capitalisation changes from the RAB
- Other incentive schemes
- Treatment of shared assets

Each of these rule change proposals is considered in the following sections.

Setting estimates of required expenditure

The AER is of the view that the NER, as currently drafted, limit its ability to assess the Network Service Providers' (NSPs') expenditure proposals and to amend them.

In particular, the AER has noted that the requirement to accept a proposal that "reasonably reflects" the required expenditure allows network businesses to propose the highest possible forecast and leaves the burden on the AER to prove that the forecast is not efficient and not prudent. In addition, in the context of electricity distribution regulation, the AER has noted that it must only amend a proposal to make it capable of being approved under the rules and that any substituted proposal must be formed on the basis of the distribution businesses' proposal. The AER has indicated that these are material restrictions on its discretion which effectively require it to conduct a "bottom up" line by line assessment of the businesses' proposals. This creates a high evidentiary burden on the AER particularly when it faces significant information asymmetries in evaluating the businesses' proposals.

The AER has therefore proposed rule changes that strengthen the AER's ability to interrogate a revenue proposal and, where necessary, determine a substitute forecast taking into account a range of information.

Consistent with the views set out above on reducing the level of prescription in the regime and moving to an outcomes-based approach, Victoria considers that the AER should be provided with sufficient discretion to determine an efficient level of forecast expenditure taking into account a broad range of information and innovative regulatory tools, including the network businesses' proposals, as well as benchmarking and activity based analysis and other expert input where appropriate. Such an approach would reduce the current focus on line-by-line assessments of expenditure proposals currently employed by the AER which leaves the AER subject to significant information asymmetries, to the detriment of the long term interests of consumers under the National Electricity Objective (NEO).

At the recent Australian Energy Market Commission forum on the AER rule changes, some stakeholders noted that they consider that the AER already has sufficient discretion and powers to determine efficient forecasts and that the rule changes are therefore not necessary.

Victoria considers that, to the extent that there is legal uncertainty regarding the extent of the AER's discretion, it is preferable that the rule changes are approved so as to put the matter beyond doubt and to reduce the potential for future legal challenge before the Australian Competition Tribunal.

I therefore support any rule changes that strengthen the AER's powers in this regard, while ensuring that the NEO is met.

Expenditure objectives, factors and criteria

The AER has proposed consequential changes to the expenditure objectives, factors and criteria arising from the proposed changes to strengthen the AER's powers to interrogate and amend expenditure forecasts. I support any consequential amendments that are required.

Capex incentives

The AER has queried whether the current economic regulatory framework provides appropriate incentives for efficient capital investment, in particular whether the current regulatory asset base (RAB) roll forward mechanism sufficiently disciplines capex in excess of the original forecast. The AER has proposed that the RAB roll forward mechanism be amended such that⁵:

... only capex up to the forecast would be automatically added to the RAB. Any expenditure in excess of the forecast would be subject to a 40/60 sharing factor. Under this approach, 40 per cent of capex in excess of forecast would be funded by shareholders and the remaining 60 per cent would be borne by customers via an adjustment to the RAB at the time of the next network determination.

The AER has argued that the proposed rule change will strengthen the incentives on businesses to incur only efficient capex.

I support any changes to the NER that incentivise efficient and prudent capex. However, there are perverse incentives associated with the rule change proposed by the AER.

If the proposed rule change was made, the businesses would have a greater incentive to over-inflate their capital expenditure proposals to the AER as part of a revenue determination to reduce the risk that the level of capital expenditure included in a revenue determination is inadequate. The AER would therefore have a larger capital expenditure program to assess in making a determination on the level of capital expenditure.

The rule changes set out in sections 6.2 and 6.3 of the AER's proposal may increase the ability of the AER to reduce the level of capital expenditure. However, if the starting point is higher, then the end point may be similar to the outcome under the existing regime. Customers may then pay more than required if an efficient level of capital expenditure had been determined.

⁵ AER, *Economic regulation of transmission and distribution network service providers, AER's proposed changes to the National Electricity Rules*, September 2011, page 40

If the AER continues to roll the RAB forward using depreciation based on actual capital expenditure, and if the capital expenditure included in the revenue requirement is higher as a result of this proposal, then customers will ultimately pay more.

If the rule change is made, the privatised businesses will never invest more than their forecast capex, even where it is efficient to do so. For example, the privatised businesses may not invest:

- To improve reliability even where they are incentivised to do so through the operation of the Service Target Performance Incentive Scheme
- To augment the network to connect new customers
- To improve safety outcomes, including improving Bushfire Mitigation Plans

This may lead to deterioration in services to customers and is inconsistent with the NEO.

It is noted that the AER has also proposed additional rule changes to address these concerns:

- Extend the provision to re-open revenue determinations from transmission to distribution businesses
- Extend the contingent project framework from transmission to distribution businesses with a trigger threshold of \$10 million
- Lock in a one per cent materiality threshold for cost pass throughs for distribution businesses, consistent with transmission businesses

While these rule change proposals deal with the uncertainty associated with a small number of large projects, which is a characteristic of a transmission business, they do not deal with the uncertainty associated with a larger number of small projects, which is a characteristic of a distribution business. As such, the concern that privatised businesses will not invest, even where it is efficient to do so, remains.

Additionally, if there is a risk that the capital expenditure included in a revenue requirement is insufficient for the level of efficient investment required during a regulatory control period, the businesses may argue for a higher weighted average cost of capital (WACC). This would further exacerbate concerns relating to the WACC decisions.

The AER has identified that there is an incentive to overspend where the true WACC is lower than the regulated WACC. This is partly correct – there is an incentive to overspend only where future expectations of the regulated WACC are greater than the true WACC over the life of the asset. It is noted that the AEMC will be considering changes to the rules relating to WACC. These changes may ensure that future expectations of the regulated WACC are more aligned with the true WACC and thereby address the issue.

However, the core issue appears to be the access to funding. If funding is constrained, then businesses will necessarily be more disciplined in prioritising investment and thereby invest more efficiently. If funding is less constrained, then businesses will tend to be less disciplined in prioritising investments and are more likely to invest inefficiently.

In proposing that only 60 per cent of the capex overspends are rolled into the RAB, the AER has compared its proposal to the capex rolling incentive used by the Office of the Regulator General (now the Victorian Essential Services Commission). The 2001-05 price determination for the Victorian electricity distributors is referenced. It is assumed that the AER is referring to the efficiency carryover mechanism that was previously applied to capital expenditure.

It is misleading to compare the two proposals as the efficiency carryover mechanism did not apply to capital expenditure from 2006. The Essential Services Commission commented that:

Reductions in capital expenditure below forecast can be the result of any, or a combination, of: efficiency gains, the deferral of capital expenditure projects between regulatory periods; changes in external expenditure drivers (for example, lower than anticipated peak demand); or overstatement of expenditure requirements when the 2001-05 forecasts were set.

In light of these various sources of spending below forecast, it is difficult to isolate whether or not the efficiency carryover mechanism has provided any greater efficiency incentive than that already provided within the current five year regulatory review cycle.

...

The Commission is not confident that the reported capital expenditure efficiencies of the 2001-05 regulatory period are sustainable or that these will be shared with customers given the increase in forecast 2006-10 capital expenditure. To be consistent with the obligations to ensure a fair sharing of efficiency benefits, the Commission has therefore decided not to apply an efficiency carryover mechanism to capital expenditure during the 2006-10 regulatory period.

Additionally, the Office of the Regulator General's / Essential Services Commission's efficiency carryover mechanism:

- Was symmetric rather than asymmetric, as proposed by the AER,
- Was based on incremental differences between actual and forecast expenditure rather than absolute differences
- Made an adjustment for a limited period rather than for the life of the asset

As a result, the likelihood of large negative carryover amounts was reduced compared to the AER's proposal.

The AEMC is urged to consider the perverse incentives associated with the rule change proposed. It should also consider alternatives that address the core issues, noting that the most efficient and effective way to address the core issue may be changes to governance arrangements which strengthen the discipline around accessing funding, rather than through the economic regulatory regime.

Use of actual or forecast depreciation

Clause 6.12.1(18) of the NER provides the AER with discretion to roll forward the RAB of the Distribution NSPs (DNSPs) from one regulatory control period to the next using depreciation based on actual or forecast capital expenditure (commonly referred to as actual depreciation or regulatory depreciation, respectively). The discretion was provided to the AER as it was recognised that the circumstances differ across the jurisdictions and therefore it was not appropriate to prescribe the same approach in all jurisdictions.

In its Final Decision on the revenue for the Victorian electricity distributors for 2011-15, the AER determined that the RAB should be rolled forward using depreciation based on actual capital expenditure from 2016. This decision was made, in part, because⁶:

The use of actual depreciation is also consistent with transmission regulation (prescribed in chapter 6A) and also the AER's recent distribution determinations in New South Wales, Australian Capital Territory, Queensland and South Australia.

I appealed this decision on the basis that it is not consistent with the NEO or the revenue and pricing principles contained in section 7A of the National Electricity Law. A decision has not yet been made by the Australian Competition Tribunal.

The AER has identified that if actual depreciation is used to roll forward the RAB, and if the differences between actual and forecast depreciation are likely to result from uncontrollable factors, the temporary deferral of investments or the systematic over-forecasting of capex, then the windfall gains/losses will be higher than if forecast depreciation is adopted. It has proposed that the NER be amended so that the AER can apply either actual or forecast depreciation when rolling forward the Transmission NSPs' (TNSPs') RABs, consistent with the discretion provided for the DNSPs.

For these reasons, I strongly support this rule change – the prescribed use of actual depreciation for TNSPs in the NER can thus not be used as a rationale for routinely adopting actual depreciation for rolling forward the RAB in future revenue determinations. Rather, the specific circumstances of each jurisdiction can be taken into consideration.

Contingent projects, capex reopeners and pass through events

The AER has identified that the current economic regulatory regime attempts to deal with the risk of under and over forecasting expenditure by limiting regulatory discretion. As indicated above, it has proposed to increase the level of regulatory discretion and include the following provisions in the NER for DNSPs to deal with uncertainty and unforeseen events:

- Extend the provision to re-open revenue determinations from transmission to distribution businesses
- Extend the contingent project framework from transmission to distribution businesses with a trigger threshold of \$10 million

⁶ AER, *Victorian electricity distribution network service providers, Distribution determination 2011-2015: Draft decision, June 2010*, page 452

- Lock in a one per cent materiality threshold for cost pass throughs for distribution businesses, consistent with transmission businesses

While I support these proposed rule changes, it is unlikely that they will have a material impact on the DNSPs' expenditure forecasts. While these rule change proposals will deal with the uncertainty associated with a small number of large projects, which is a characteristic of a transmission business, they do not deal with the uncertainty associated with a larger number of small projects, which is a characteristic of a distribution business.

The provision to re-open a revenue determination was incorporated in the Victorian economic regulatory regime but is expected to be rarely exercised.

The contingent project framework provides for a very small number of large projects that are infrequently undertaken by distribution businesses.

Specifying a materiality threshold for cost pass throughs provides greater certainty as to which events may be classified as a pass through event. The threshold strikes an appropriate balance between the interests of the businesses and customers. If the materiality threshold was lower, the economic regulatory regime would operate more as a cost of service regime than an incentive-based regime. If the materiality threshold was higher, the businesses would bear a higher risk.

To ensure the appropriate balance is retained over time, I suggest that the materiality threshold for cost pass throughs and for contingent projects be indexed to CPI.

Excluding related party margins and capitalisation changes from the RAB

In the recent revenue determination for the Victorian electricity DNSPs, the AER allowed the DNSPs to roll margins on related party contracts into their RABs despite the AER recognising that⁷:

... there is a perverse incentive in the RAB roll forward which is not in the long term interests of consumers. This also arguably undermines the incentive-based regulatory regime in Chapter 6.

I appealed this decision on the basis that the literal interpretation of the NER leads to perverse and unintended outcomes and undermines the incentive-based regulatory regime. A decision has also not yet been made by the Australian Competition Tribunal on this matter.

To address this perverse incentive, the AER has proposed that the NER be amended to exclude capex relating to changes in capitalisation policy and related party margins from the RAB roll forward at the end of the regulatory control period on the basis that such amounts were not incurred in accordance with their treatment on an ex ante basis.

I strongly support this rule change – in the absence of this rule change, the NSPs have an incentive to enter into related party contracts for any arbitrary amount so that the capex they

⁷ AER, *Victorian electricity distribution network service providers, Distribution determination 2011-2015: Final decision*, October 2010, page 457

subsequently incur can be rolled into the RAB. Customers will continue to pay a return on and of the related party margins for the life of the asset.

Other incentive schemes

Under the current NER, a full rule change process is required to introduce innovative incentive schemes. The economic regulatory regime is not able to continually evolve in line with best practice, as previously occurred in the Victorian economic regulatory regime. The AER has proposed that it be able to develop new incentive schemes consistent with principles that are set out in the NER.

The current level of prescription in the rules has made it difficult for the AER to respond to changes in the market (for example, changes in the financial markets) and to ensure that the economic regulatory regime reflects evolving best practice (for example, ensuring that the businesses do not make windfall gains or losses in the transition to the national regime and introducing new incentive arrangements over time).

As a result, decisions have been made by the AER that do not protect the long term interests of consumers.

I therefore support the rule change as it will provide the AER with more discretion to develop innovative incentive schemes that are in line with best practice and that ultimately protect the long term interests of consumers.

Treatment of shared assets

The AER has identified that users who currently pay for standard control assets receive no compensation for the use of these assets to deliver other services. This is inconsistent with the approach that was previously adopted by the jurisdictions. The AER has proposed a rule change that would allow the AER to include a revenue adjustment or mechanism for situations where shared assets are used for non-standard control services, including unregulated services.

I agree that users should appropriately be compensated where assets are shared between different services.

However, I am concerned that the cost allocation method adopted by the AER may be unnecessarily limiting its discretion in the treatment of shared assets, and in other regards. If properly designed, the cost allocation method should be providing for an asset to be allocated to a range of different services and for this allocation to vary over time as the circumstances change. I urge the AEMC to consider whether the framework for the allocation of costs is appropriate given the comments provided in the AER's submission, prior to making this rule change.

Determination of the rate of return

The AER has proposed rules changes that relate to:

- The status of the WACC review in determinations
- Role of the persuasive evidence test and previously adopted values

- The timing of WACC reviews
- Definition of the debt risk premium
- Use of post tax nominal WACC in gas decisions

Additionally, the EURCC has proposed⁸:

...that the return on debt, whether for government or privately owned network service providers, should reflect the actual cost of debt. Regulated network service providers should, in principle, not profit on the debt they raise.

It has also proposed that some of the WACC parameters be prescribed in the NER rather than determined as part of the WACC review.

Each of these rule change proposals is considered in the following sections.

The status of the WACC review in determinations

The parameters determined by the AER in the WACC review must be applied in transmission revenue determinations and must applied in distribution revenue determinations unless there is persuasive evidence justifying a departure from a particular parameter. The ability to depart from the parameters in the WACC review at each distribution determination was provided because of the pre-existing differences in WACC parameters across jurisdictions.

The AER has identified that the current arrangements:

- Incentivise DNSPs to continually repackage arguments and data which have been previously considered by the regulator
- Have resulted in high administrative and opportunity costs to continually review certain parameters
- Are asymmetric and detract from the AER's (and Tribunal's) ability to determine whether the overall rate of return is a reasonable outcome.

I agree with the issues raised by the AER. As the first cycle of revenue determinations for the DNSPs is almost complete, there does not appear to be any rationale for continuing to allow the parameters to be departed from as part of a revenue determination.

The AER has also proposed that the provisions in the NGR in relation to the WACC review should mirror the provisions in the NER. I support this proposed rule change as there would not appear to be any valid justification for not having similar provisions.

Role of the persuasive evidence test and previously adopted values

The AER has identified that there is uncertainty around the interpretation of "persuasive evidence" in assessing whether a WACC parameter should be amended. It has proposed a rule change requiring the AER to have regard to the previously adopted value or method and the NEO. It has suggested that this approach is consistent with good regulatory practice and

⁸ Proposal by Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt*, 17 October 2011, page 6

ensures that undue weight is not placed on consistency with previous regulatory outcomes at the expense of setting parameters that are appropriate or otherwise in accordance with the interests of stakeholders.

As the intent of the proposed rule change is consistent with the previous rule, and as it removes uncertainty around interpretation, I support the proposed rule change.

The timing of WACC reviews

The AER proposes to align the provisions relating to the timing of WACC reviews for TNSPs and DNSPs. As this would result in a more efficient process, I support the proposed rule change.

Definition of the debt risk premium

The AER has identified that the current definition of the debt risk premium in the NER significantly constrains its ability to set an efficient cost of debt which is consistent with the NEO and the revenue and pricing principles. It has proposed that the debt risk premium be defined as part of the five yearly WACC review rather than be prescribed in the NER.

In contrast, the EURCC has proposed that the calculation of the return on debt should be specified in the NER. The Committee is of the view that this approach best meets the NEO.

I share the concerns of a number of stakeholders regarding the recent WACC decisions and the current appeals of the WACC decision in the recent Victorian revenue determination by the Victorian DNSPs. While I did not intervene in this appeal, I have been observing it closely. I therefore support any rule changes that will ensure that the WACC decision is consistent with the NEO and the revenue and pricing principles.

The experience with the current rules indicates that the level of prescription in the rules is too high and does not accommodate the changes that have occurred in the financial markets. An approach, which includes principles in the NER and the determination of the parameters as part of the WACC review, provides more flexibility to accommodate changes in the financial markets.

Use of post tax nominal WACC in gas decisions

The AER has proposed that a post tax nominal WACC be prescribed for gas decisions, consistent with the rules for electricity decisions.

I support this proposed rule change. I support consistency between the gas and electricity businesses and agree with the AER that a pre tax WACC can lead to systematic overcompensation for company tax.

I also note that the businesses should be indifferent to a nominal or real framework, noting the AER's preference to use a nominal framework.

EURCC proposal

The EURCC has proposed that the WACC for privately owned NSPs be based on an index of investment grade corporate debt issued in Australia. It has argued that the cost of debt

provided in recent WACC decisions is considerably higher than the actual cost of debt, particularly for government-owned NSPs. Accordingly, the cost of debt provided for government-owned NSPs should be less than that provided for privately-owned NSPs.

The regulatory practice in Australia has been to determine the WACC based on a benchmark firm, rather than an actual firm. The WACC parameters, including for example the debt equity ratio, are based on the benchmark firm.

In principle, Victoria does not support a return on debt that reflects actual cost of capital because it is characteristic of a cost of service economic regulatory regime, which provides no incentive for the NSPs to obtain a cost of capital that is less than the WACC decision.

Nevertheless, the EURCC's proposal that the return on debt for privately-owned NSPs be based on an index of investment grade corporate debt issued in Australia does warrant consideration as it seeks to provide incentives for NSPs to control their debt costs (albeit one based on actual costs).

Regulatory decision-making process

The AER has proposed rule changes that relate to:

- Submissions received during a determination process
- Identification and use of confidential information
- Framework and approach paper
- Correcting for material errors
- Timeframe for the conduct of WACC reviews
- Timeframe for the assessment of cost pass through events, contingent projects and capex reopeners
- Consequential amendments to process matters

Each of these rule change proposals is considered in the following sections.

Submissions received during a determination process

The AER has identified that the submission by the NSPs of voluminous material, subsequent to the lodging of their revenue or regulatory proposals (in particular, after their revised proposals), does not allow for effective consultation and for the AER to make timely decisions. The AER has proposed to restrict a NSP making submissions on their own initial proposal, the AER's draft decision, or their own revised proposal.

I agree that the submission of voluminous material during the determination process does not allow for effective consultation, but am concerned that the rule change proposed by the AER may not allow for due process. I urge the AEMC to consider this carefully.

The main impediment to effective consultation is the sheer volume of information that is submitted by the NSPs in the absence of an AER consultation paper prior to the draft decision. The experience within the Victorian economic regulatory regime was that stakeholders are more able to engage effectively in the determination process if an Issues Paper is released by the AER early in the process which summarises the key information

provided in the regulatory proposals and identifies the key issues to be considered as part of the determination process.

The NER currently allow for an Issues Paper to be released but do not require it. The timeframes for the determination process may need to be amended to more effectively allow for the Issues Paper.

Identification and use of confidential information

The AER has identified that there is an asymmetry between the confidential information that is submitted by NSPs as part of their proposals and that provided in stakeholders submissions. Lesser weight may be placed on confidential information provided in stakeholder submissions as it has not been subjected to public scrutiny. A similar discretion does not apply to confidential information submitted by NSPs as part of their proposals, however the AER has proposed that it be provided with a similar discretion.

I agree that the AER should have the discretion to put a lesser weight on any confidential information that has not been subject to public scrutiny, noting that this discretion would need to be exercised with care by the AER as the NSPs are likely to include commercially sensitive information in their proposals that is genuinely confidential.

Framework and approach paper

The AER has proposed rule changes to:

- Remove the requirement to consult on the application of each incentive scheme in the framework and approach paper as there is a low level of interest and any decisions are not binding
- Allow any positions in the Framework and Approach paper on service classification and form of control mechanism to be amended if the positions are no longer appropriate due to circumstances that were unforeseen at the time of the framework and approach paper

I do not support removing the requirement to consult on the application of each incentive scheme in the framework and approach paper. I have concerns regarding the level of consultation as part of the determination process and so would be reluctant to support any move that further reduces the level of consultation.

Experience indicates that allowing the service classification and form of control mechanism to be amended post the framework and approach paper is a pragmatic approach. I therefore support the proposed rule change.

Correcting for material errors

The AER has proposed that the provisions to amend revenue determinations to correct for material errors should be consistent for DNSPs and TNSPs.

I agree with the issues identified by the AER and support the rule change proposed.

Timeframe for the conduct of WACC reviews

The AER has proposed an extension from 80 business days to 100 business days for the WACC reviews.

Given the complexity of the WACC reviews and the materiality of that decision to a NSP's revenue, I support the proposed rule change.

Timeframe for the assessment of cost pass through events, contingent projects and capex reopeners

The AER has proposed the timeframe for making determinations on cost pass through events, contingent projects and capex reopeners be 40 business days with the power to extend this to 100 business days in total.

I support this proposed rule change – while many decisions can be made within the 40 business day timeframe, some decisions may be far more complex and require an extended timeframe.

Consequential amendments to process matters

The AER has identified a range of consequential amendments to the NER arising from the rule changes discussed above. Given my support for most of the proposed rule changes, I support the consequential proposed rule changes.

Conclusion

Victoria has supported the development of the national economic regulatory regime as part of the broader privatisation and reform of the energy sector which commenced in the mid 1990s.

Victoria supports the specific objective for developing the national economic regulatory regime which was to balance the interests of businesses and consumers. However, the experience with the regulatory regime over the last five years indicates that the balance that was sought has not been achieved.

For these reasons, I support rule changes that have been proposed by the AER in relation to the following:

- Capex and opex framework
 - Setting estimates of required expenditure
 - Expenditure objectives, factors and criteria
 - Use of actual or forecast depreciation
 - Contingent projects, capex reopeners and pass through events
 - Excluding related party margins and capitalisation changes from the RAB
 - Other incentive schemes
 - Treatment of shared assets, but urge the AEMC to consider whether amendments to the cost allocation framework would be more appropriate
- Determination of the rate of return
 - The status of the WACC review in determinations
 - Role of the persuasive evidence test and previously adopted values

- The timing of WACC reviews
- Definition of the debt risk premium – I support the AER's proposal to make the NER less prescriptive and determine the debt risk premium parameters through the WACC review, but believe that the EURCC's proposal also warrants consideration by the AEMC
- Use of post tax nominal WACC in gas decisions
- Regulatory decision-making process
 - Submissions received during a determination process
 - Identification and use of confidential information
 - Framework and approach paper – to allow positions in the Framework and Approach paper on service classification and form of control mechanism to be amended if the positions are no longer appropriate due to circumstances that were unforeseen at the time of the framework and approach paper, but not to remove consultation on the application of each incentive scheme
 - Correcting for material errors
 - Timeframe for the conduct of WACC reviews
 - Timeframe for the assessment of cost pass through events, contingent projects and capex reopeners
 - Consequential amendments to process matters

However, I do not support the following proposed rule change:

- Capex incentives – I am concerned with the potential for perverse incentives to be created if the AER's proposed rule change to only allow 60 per cent of capex overspends to be rolled into the regulatory asset base was made, leading to inefficient investment outcomes.

