



CitiPower Pty  
ACN 064 651 056  
www.citipower.com.au

Head Office: 40 Market Street Melbourne Victoria  
Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 DX 433 Melbourne  
Postal address: Locked Bag 14090 Melbourne Victoria 8001 Australia



Powercor Australia Ltd  
ACN 064 651 109  
www.powercor.com.au

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Dr. John Tamblyn  
Chairman  
Australian Energy Market Commission  
PO Box H166  
AUSTRALIA SQUARE NSW 1215

Email: [submissions@aemc.gov.au](mailto:submissions@aemc.gov.au)

Dear Dr. Tamblyn

### **Economic Regulation of Transmission Services**

Thank you for the opportunity of commenting upon the Australian Government Solicitor advice, dated 10 October 2006, to the Department of Industry Tourism and Resources (**AGS advice**), and the AEMC's Draft Revenue Rule's adoption of a limited 'propose/respond' decision making model for expenditure forecasting.

#### ***AGS Advice***

- 1 The AGS advice revisits the debate as to the respective merits and disadvantages of the 'propose / respond' versus 'consider / decide' decision making approach to expenditure forecasts. The AGS advice however focuses on the negative aspects of a propose/respond model, but says little about either the advantages or disadvantages of consider / determine.
- 2 The main (indirect) reference to the consider/determine model in the AGS advice is the comparison of capital and operating forecasts versus actual regulatory decisions set out in a table at paragraph 4. This highlights the discrepancy between the initial proposals of service providers and the final allowances provided by the regulator. In each such instance however the regulatory approach is consider / determine, under this model the businesses arguably have less incentive to put in forecasts that are not at the upper end of the reasonable range than would be the case under a propose / respond model. This table therefore does not present any surprises in the context of a consider / determine process. It however does not prove anything in relation to a process which puts different incentives and limits upon the regulated business, such as the form of propose / respond proposed in the AEMC draft Rule.

- 3 Despite not providing any critique of the consider/determine model, the advice goes on to suggest that the form of propose/respond in the draft Rules should be replaced by:
  - A 'best estimate' model, which in effect is a 'limited consider/decide model' (paragraph 69 AGS Advice); or
  - a 'clearer' pure consider / decide model (paragraph 70 AGS Advice).
- 4 The 'best estimate' approach will require that the AER independently formulate its own forecasts of operating and capital expenditure for a regulated business. Any estimate provided by the regulated business will inevitably differ from the estimate of the AER, not least because the businesses forecast will be based upon best information and will have been formulated by experts within the business concerned. The AER will however be reliant upon its own internal resources and third party consultants. However, to the extent that any such forecasts differ, the AER would immediately have the discretion to impose its own 'best estimate' over that offered by the business. For this reason we see no practical difference between this 'best estimate' approach and the limited consider/ determine decision making model. The AGS Advice itself appears to acknowledge this point when it notes that the 'best estimates' approach will be 'much closer to a limited consider/decide model'.
- 5 We therefore consider that this debate remains between adoption by the AEMC in its draft Rules of a limited form of consider/determine, or a limited form of propose / respond regulatory model. In each case the regulatory model is 'limited' because the discretion of each of the formulating business, or AER, is subject to the objectives set out in the National Electricity Law and Rules. We agree with the conclusion given in the AGS advice that the draft Rules adopt the limited propose/ respond model in relation to expenditure forecasts and do not consider this point to be contentious.
- 6 The following submission therefore addresses the relative merits of each model in the context of the prior debate on this issue.

### ***Expert Panel Report***

- 7 CitiPower and Powercor consider that the respective merits of these two models was well reviewed in the Expert Panel on Energy Access Pricing Report to the Ministerial Council on Energy (**Expert Report**). The Expert Panel took as a starting point that:

'Many of the inputs required to derive access prices cannot be estimated with precision, or pertain to future outcomes that cannot be forecast with precision. Thus there is a range (and potentially, a wide range) within which a reasonable person may consider that the relevant input may reside...' (page 74 Expert Report).
- 8 The Expert Panel went on to note that the breadth of what may be reasonable will depend upon how prescriptive the remainder of the regime is and that the reasonable range will be narrowed (and possibly eliminated) where a very prescriptive regime is

introduced. The Expert Panel then looked (in the context of the Productivity Commission's recommendations of amendments to the Gas Code) at each of propose/respond and consider/determine approaches.

9 The Expert Report (at pages 77 & 78) usefully lists the arguments against the consider/determine model (which are quoted as supporting the propose/respond model). In brief these are:

- *Truncated regulatory returns* – conventional regulatory practices (consider/determine) lead to artificially constrained returns and hence under investment in socially important infrastructure.
- *Asymmetric risk from regulatory error*: even if there is no systemic bias in regulatory decisions; the costs or regulatory error are asymmetric i.e. under recovery by a regulated business will impose a higher social cost (though under investment in infrastructure) than any over recovery through inflated rates of return;
- *Systemic regulatory bias* – regulators are prone to 'self justification' through setting prices that will be popular with consumers (and potentially government) which results in a systemic bias to wards lower than justified regulated returns;
- *Regulatory Uncertainty arising from methodology and data* – there is no unique methodology upon which to base an estimate of a competitive market return i.e. no one right answer. In these circumstances the reasonable and defensible estimate of the owner of the asset of the appropriate return is to be preferred to that of a regulator.
- *Asymmetric knowledge* – infrastructure owners are in the best position because of their knowledge base and intimate engagement with the industry;
- *Reduced Regulatory Complexity* – assessing proposals against broad estimates of ranges is a less demanding task for the regulator than setting an 'optimal' or best price and therefore can be accomplished more quickly and at a lower cost.

10 While CitiPower /Powercor agree that all these risks will not necessarily exist for all regulatory and price decisions, these are generally accepted regulatory risks that arise from the consider/determine model. We submit that they are valid risks and remain substantial reasons for not continuing the consider/determine model in relation to expenditure forecasts.

11 In this regard we note that the Expert Panel concluded that:

'...it is not appropriate for a global presumption to be adopted in the law or the Rules in favour of a regulator accepting a regulated entities proposal. Equally the panel concludes that it is not appropriate for the Law to mandate a receive – determine model. The complexity and differing characteristics of each element of the service providers proposal are such that the Law cannot itself prescribe a

single overriding test to be applied by the AER in assessing service provider proposals.' (page 90)

- 12 We understand that the draft Rules accord with this recommendation of the Expert Panel, by not applying a single overriding test for a service provider proposal, but instead using different approaches for different aspects of that proposal. Relevantly, for the expenditure forecasts aspect of a service provider proposal only, the AEMC has adopted a limited propose / respond model. This is appropriate where there is no one 'best' answer and the party that is objectively best qualified to make the estimate is the regulated business.
- 13 The AGS advice however proposes 'an appropriately worded 'best estimate' test to...make it clear that the AER should assess whether a proposal is the optimal amount...' (Page 3). The Australian Competition Tribunal decision in *Application by Gasnet Australia* (as quoted in the AGS advice page 9) however makes it clear that in analogous circumstances (setting a tariff under the Gas Code) there is no 'single correct figure' when forecasting such matters and that 'different minds acting reasonably can be expected to make different choices within a range of possible choices'<sup>1</sup>. In this circumstance it appears peculiar that the AGS advice then proposes that the AER will determine an 'optimal amount' or 'best estimate', which presupposes that such a single 'correct' or best figure exists.
- 14 Further, the AGS advice variously proposes a 'best, optimal or most appropriate estimate' or that the regulator be satisfied that any forecast capital or operating costs are the 'best estimates that are reasonably possible in the circumstances'. These are not tests as for which any regulatory or judicial precedent exists and will therefore introduce greater regulatory uncertainty. By way of contrast the Australian Competition Tribunal and the courts are familiar with applying a concept of 'reasonability' in the context of defined parameters, such as will exist under the draft Rules. The logic of moving from a known approach to an untested one is not addressed in the AGS advice.

#### ***CitiPower/Powercor Recent Experience with 'Consider/Determine'***

- 15 CitiPower and Powercor's experience of the consider/determine approach in the context of the 2006 Victorian Distribution Price Reset, which used the consider/determine model, supports the existence of the regulatory risks highlighted by the Expert Panel.
- 16 Following the filing of the price-service offering in the Victorian distribution price resets the regulator rapidly progressed to its own 'best' estimates. The balance of the price review process was then spent debating these.
- 17 The lack of weight placed upon all regulated businesses forecasts is demonstrated by the Essential Service Commission's consideration of both capital expenditure forecasts and service targets in the 2006-10 price review. In the case of capital expenditure the

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<sup>1</sup> Australian Competition Tribunal, *Application by Gasnet Australia Operations Pty Ltd* [2003]ACompT 6 (23 December 2003) paragraph 29.

ESC substituted capital expenditure forecasts presented by all 5 Victorian distributors (which was based on the same analysis the ESC used at the previous review) with a uniform 30% increase on historical capital expenditure. Such an approach ignored any consideration of business specific growth differentials, network ages and condition and compliance costs. Similarly the ESC arrived at customer connection capital requirement which was 50% of CitiPower's actual outturn capital requirement over the period 2001-5.

- 18 In this example the propose/determine model was, in view of the businesses, essentially a 'determine' model. Debate centred around the regulator's 'best estimate' to exclusion of the price-service proposal. This model demonstrably fails to recognise the distributor is best placed to establish the expenditure requirements and service standards to meet the needs of its customers and its own operational needs and instead places the regulator in the role of network manager.
- 19 In our view the key deficiencies of the propose/determine model are therefore that:
- The regulated business has the expertise and information necessary to develop the 'best' price service proposal, yet its proposal may be ignored at the regulator's discretion;
  - A regulated business can have no confidence as to the weight its price/service proposal will be given by the regulator and therefore has no overriding incentive to put in its most robust realistic proposal, avoiding any elements of an ambit claim;
  - The price review focus inevitably shifts to the regulator's draft determination, as soon as it becomes available. If the regulator substantially disregards the regulated entities price service proposal, this lends itself to an adversarial process and a potentially litigious outcome.
  - Assuming the regulator has issued a draft based upon its own estimates and is not swayed following submissions on its draft, the determination that becomes final is one that is not based upon best information and therefore will not necessarily deliver 'an outcome that is efficient from the perspective of society as a whole.'
  - This type of process is inimical to the concept of regulatory certainty and ultimately has a chilling effect on investment, which is to the detriment of the long term interests of consumers.

### ***Propose / Respond Model***

- 20 The AGS advice focuses upon the alleged 'upward bias' of the propose/respond model as being a reason this approach is not preferred. In particular it refers to:

'the use of the 'reasonable' estimate' test, uncertainty in forecasting, the existing case law in Gasnet and Telstra and the role of pricing principles in resolving conflict, will result in the AER being required to accept a range of forecasts that is higher than those it would determined as the most appropriate or best estimate' (Paragraph 53).

- 21 The Expert Panel also refers to this feature of the propose/respond model and notes it arises because 'it seems improbable that, given a choice of proposing an estimate within a range, the regulated entity will opt for other than its estimate at the upper end of the range'.
- 22 However this potential for systemic upward bias is one of the reasons that this model is to be preferred to consider/determine, as it remedies the risks of truncated returns and asymmetric risk from regulatory error referred to above. When viewed in the context of the acknowledged greater potential for societal harm from infrastructure under investment (versus any business over recovery), this potential is not a convincing reason for not adopting the propose/respond approach.
- 23 In the medium to long term any such upward bias is to an extent self correcting. As forecasts are based upon historical expenditure (as influenced by projected changes) a substantial underspend over more than one regulatory period is likely to result in the range of reasonable forecast of expenditure for a subsequent period being lower.
- 24 We submit that any potential for a systemic upward bias is best addressed by the Rules themselves. In particular, by outlining the ambit of 'reasonable' and by allowing the AER to specify the form and level of substantiation of such service provider forecasts. Further, the ability to have a reasonable forecast accepted by the AER, thereby avoiding the AER imposing its own forecasts, is a significant incentive for service providers to provide a estimate that is well within the boundaries of 'reasonability'. The current draft Rule achieves this.

### *Conclusion*

- 25 The AEMC has asked whether the Rules should provide that:
- A TNSP's proposal must be accepted if the AER is satisfied that the forecast expenditure satisfies the criteria of the Rules; or
  - The AER should have residual discretion to substitute its own reasonable estimate of forecast expenditure in those circumstances.
- 26 In essence these questions are substantially 'should the AEMC adopt a limited consider/determine or a limited propose / respond decision making model?' It follows from what is said above that CitiPower & Powercor support the current wording of the draft Rule for transmission revenue regulation. Accordingly the businesses answer to these questions is 'yes' and 'no'.
- 27 Where it is necessary to forecast expenditure and it is accepted that this is not (and cannot be) a precise science, we consider that the starting point should always be best information. That will always be forecasts by the regulated business. For the reasons given above, to override this with a residual discretion to move to a regulators 'best estimate' is to disregard this best information and will invoke all the acknowledged regulatory risks of the consider / determine approach.

- 28 Conversely, the only regulatory risk of propose/respond that is been identified in the AGS advice is its alleged systemic upward bias. Addressing this potential for over recovery is however the role of the boundaries specified in the Rules and an implicit incentive for the regulated business to provide robust 'reasonable estimates', to avoid any potential of it being supplanted by the regulator's own forecasts. This can be distinguished from the consider/determine regulatory model, where regulated business has less such incentive.
- 29 The draft Rules address this by their requirements that the AER to have regard to specified criteria and evidentiary materials and that TNSP's make a complete service proposal in conformity with AER guidelines. These requirements limit the ability of the regulated business to make ambit claims and give the AER a basis to legitimately reject any such forecasts which are not 'reasonable' in the context of the factors provided in the Rules and Law.
- 30 We also note that the AEMC's approach in the draft Rules is an express adoption of the Expert Panel's recommendation of a 'fit for purpose' approach. Where it is necessary and can be done (such as WACC parameters)the discretion of both the regulated business and regulator is reduced or removed, while in areas, such as expenditure forecasts, where there is no 'right' answer, the discretion of regulated business is limited by reference to an objective 'reasonability' test and AER oversight.
- 31 The suggestion in the AGS advice that the AEMC adopt a test such as 'best estimates that are reasonably possible in the circumstances' introduces an untried concept for which no regulatory or legal precedent exists. Conversely the Australian Competition Tribunal and the courts are familiar with applying a concept of 'reasonability', in the context of defined parameters, as is proposed in the draft Rule. The approach suggested in the AGS advice will therefore increase regulatory uncertainty and potentially have a chilling effect on infrastructure investment in Australia.
- 32 As the MCE has expressly cited the Experts Report and the 'fit for purpose' approach with approval, there would seem to be no basis for the AEMC to now revisit this aspect of its approach in the draft Rules.

Please do not hesitate to give me a call on telephone 03) 9683 4508 or email [rgross@powercor.com.au](mailto:rgross@powercor.com.au) if you require further information on these issues.

Yours sincerely

**Richard Gross**  
**General Manager Regulation**