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5 October 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

**AER submission on AEMC draft rule determination – Economic regulation
of network service providers (ERC0134/ERC0135/GRC011)**

The Australian Energy Regulator (AER) welcomes the opportunity to provide the attached submission on the AEMC's Economic regulation of network service providers draft rule determination.

Our submission highlights that the AEMC's draft rules represent a significant improvement on the existing rules and address the major issues highlighted in the AER's rule change proposal. Our submission also highlights some amendments which would further improve the operation of the draft rules.

Should you have any questions on the issues raised in our submission, please contact Gavin Fox on (02) 6243 1249 or me on (03) 9290 1419.

Yours sincerely



Andrew Reeves
Chairman



Australian Energy Market Commission

Economic regulation of network service providers

AER submission on draft rule determination

October 2012

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1 Introduction

The Australian Energy Regulator (AER) welcomes the opportunity to provide a submission on the Australian Energy Market Commission's (AEMC) *Economic regulation of network service providers* draft rules and draft rule determination.

On 29 September 2011, the AER submitted a rule change proposal to address concerns that several features of the economic regulatory framework restricted it from making holistic and independent assessments of the efficient costs of delivering safe and reliable energy network services. As a consequence, the AER argued that consumers were paying more than necessary for a safe and reliable energy supply.

Although the AEMC has decided not to make the changes to the National Electricity Rules (rules) proposed by the AER, the draft rules do address the major concerns outlined in the rule change proposal. In particular, the AER believes that the draft rules allow us to assess the overall reasonableness of a network service provider's (NSP) regulatory or revenue proposal. There are other areas where the AEMC has made considerable improvements to the rules, particularly in respect of its proposed initiatives to improve consumer engagement.

While these amendments are significant, the draft rules still recognise the importance of investment certainty and the requirement that an NSP be given the opportunity to recover at least its efficient costs incurred in the provision of network services.

Section 2 of this submission highlights the key concerns with Chapters 6 and 6A of the rules which the AER sought to address with our rule change proposal. This discussion provides context with which we have considered the draft rules.

Section 3 of this submission comments on the threshold issue of whether the draft rules as an integrated regulatory package, allows the AER to assess the overall reasonableness of a NSP's proposal. The AEMC has proposed changes that give the AER greater ability to assess an NSP's efficient expenditure needs and has outlined a new approach to setting the rate of return on network investment. On balance, we consider that the package better allows the AER to undertake a 'holistic' assessment of the overall reasonableness of an NSP's proposal.

Section 4 of the submission discusses specific elements of the draft rules. This discussion highlights how there are many elements of the draft rules that are a significant improvement on the existing rules. However, in some instances the draft rules are more prescriptive than is necessary and therefore the AER proposes a number of amendments to improve the operation of the draft rules.

2 Issues with the existing rules

Following a review of outcomes from the first round of regulatory determinations under the current rules, the AER proposed changes to the rules to address the key deficiencies that we had identified. The key deficiencies identified that:

- the framework restricts the AER from making holistic and independent assessments of a network's capital expenditure (capex) and operating expenditure (opex) needs
- the automatic roll-in of all actual capex to a network's asset base creates incentives for overinvestment
- inconsistent frameworks for setting the cost of capital for electricity distribution, electricity transmission and gas businesses, along with constraints on the AER from setting costs that reflect current commercial practices, lead to inflated cost estimates.
- the procedural arrangements hinder effective stakeholder engagement and scrutiny of information in the regulatory process.

Capital and operating expenditure forecasts

The AER noted that the rules provide incentives for NSPs to produce conservative forecasts of their capex and opex requirements. The rules require the AER to accept these forecasts if they 'reasonably reflect' efficient, prudent and realistic expenditure. Greater than usual incentives for inflated forecasts arise under this framework because the AER is required to first establish that a proposal does not reasonably reflect efficient costs, on the basis of evidence that primarily lies with the NSP.

Further, the AER noted that the rules constrain its discretion to determine the efficient level of expenditure required. This is because in effect, whether under Chapter 6 or Chapter 6A, the rules constrain the AER to amending the NSP's proposal to the extent necessary. The proposal that is amended is the same proposal that the AER found to not reasonably reflect efficient costs. As these constraints also reduce the effective adverse consequence for the NSP in the event that the AER rejects a proposal it also contributes to incentives for NSPs to submit highly conservative forecasts.

Overall, the AER considered that the current rules restrict its ability to undertake a holistic independent assessment of the NSP's required expenditure. The AER considered that restrictions in certain areas of the current rules drew it into a line by line assessment of an NSP's "bottom up" calculations of required expenditure. A more balanced approach would allow the AER to weigh up all available information, evidence and data and make use of a range of techniques including benchmarking when assessing forecasts.

Capital expenditure incentives

The AER noted that all capex, regardless of whether it was efficient, prudent or greater than the approved expenditure forecast, is automatically rolled into the regulatory asset base (RAB) at the start of the next period. This creates incentives to overinvest because NSPs earn a return on the capex that is included in the RAB. The AER considered that new arrangements are required to place greater discipline on networks to only incur efficient capital expenditure.

The AER also recognised that there may be occasions where an NSP may need to efficiently spend more than forecast due to unforeseen changes in circumstances. Therefore it proposed enhanced ‘uncertainty regime’ measures to deal with the risks associated with uncertainty.

More generally, the AER considered that greater flexibility was required to keep up with regulatory best practice without the need for further changes to the rules. The AER argued that a mechanism to allow the development of new incentive schemes would assist with this objective.

Rate of return

The AER noted the lack of consistency between the current frameworks it is required to apply to determine the cost of capital for electricity distribution networks, electricity transmission networks and gas pipelines. It also noted concerns about how these frameworks had operated in practice, including restrictions on considering all relevant factors when setting appropriate methods or values for some weighted average cost of capital (WACC) parameters.

The AER was also concerned that the level of prescription inhibits it from ensuring that the cost of capital, through the benchmark WACC, is set in line with the debt financing practices of the sector.

This level of prescription has also led to a focus on specific WACC parameters. In turn, this has limited the extent to which the AER could undertake a holistic assessment of whether the benchmark WACC actually reflects the required rate of return for the NSPs.

Regulatory process

The AER noted that there are a number of areas where the regulatory process can be improved to allow stakeholders to more effectively engage in the process. In particular, the way in which NSPs provide information during the regulatory process currently inhibits effective engagement of other stakeholders in the process. It also limits the time available for the AER to assess that information.

Specifically, the AER noted concerns that NSPs were strategically withholding information by making submissions later in the process when that information should have formed part of their initial regulatory or revenue proposals. Further, the AER noted that broad confidentiality claims by NSPs inhibits the opportunities for stakeholders to scrutinise and comment on the information.

The AER considered that further incentives were required to ensure NSPs submit complete regulatory or revenue proposals up front, and to ensure NSPs identify specific confidentiality claims only where material is genuinely confidential.

The AER also outlined a number of other regulatory process issues where arrangements could be improved to streamline the process, improve consumer engagement or improve opportunities for robust analysis of material from NSPs.

3 Holistic assessments

As noted above, the rule change proposal highlighted that the current regulatory framework requires it to establish that the NSP's proposal does not reasonably reflect prudent, efficient and realistic costs for it to determine a substitute expenditure forecast. Given these proposals are often based on a large amount of engineering detail and a 'bottom up' calculation of the required expenditure, the current rules effectively require the AER to undertake a detailed 'line by line' assessment of a NSP's proposal. The undertaking of a line by line assessment in turn encourages businesses to submit inflated forecasts.

The limitations of a 'bottom up' approach have also been emphasised by the Expert Panel in its review of the Limited Merits Review regime in the National Electricity Law and the National Gas Law. The Expert Panel has commented that 'an assessment process that is 'bottom up only' can be expected to be at risk of serious bias.'¹

The AER considers that the draft rules do allow it to undertake a holistic assessment of the reasonableness of an NSP's proposal. Changes to the rules that enable the AER to undertake a holistic assessment of a regulatory determination include:

- amendments that increase the scope for the AER to form allowances for capex, opex and the rate of return for an NSP that are not constrained by the proposals of the NSP
- amendments that clarify the AER's ability to use benchmarking to assess the efficiency of a NSP and determine capital and operating expenditure allowances.

A more detailed description of these changes is outlined in Section 4 of this submission.

Further, the AER notes that the AEMC has provided significant clarification around the intended operation of these rules in its draft determination.

In relation to assessing capital and operating expenditure, the AEMC emphasises that the AER can undertake a more holistic assessment of these allowances.

For example, the AEMC notes that:

While the AER must form a view as to whether a NSP's proposal is reasonable, this is not a separate exercise from determining an appropriate substitute in the event the AER decides the proposal is not reasonable. For example, benchmarking the NSP against others will provide an indication of both whether the proposal is reasonable and what a substitute should be. Both the consideration of "reasonable" and the determination of the substitute must be in respect of the total for each of capex or opex.²

The AEMC also emphasises that the AER need not undertake a 'line by line' assessment in considering a business's proposal:

¹ Professor George Yarrow, The Hon Michael Egan and Dr John Tamblyn, *Review of the Limited Merits Review Regime, Stage One Report*, 29 June 2012, p. 54.

² AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations*, 23 August 2012, p. 103.

The AER could be expected to approach the assessment of a NSP's expenditure (capex or opex) forecast by determining its own forecast of expenditure based on the material before it. Presumably this will never match exactly the amount proposed by the NSP. However there will be a certain margin of difference between the AER's forecast and that of the NSP within which the AER could say that the NSP's forecast is reasonable. What the margin is in a particular case, and therefore what the AER will accept as reasonable, is a matter for the AER exercising its regulatory judgment.³

In relation to considering the rate of return, the AEMC emphasises that what is important is the overall assessment rather than the individual rate of return parameters.

...it is important the rules allow the inter-relationships between parameters to be appropriately considered and for the regulator to focus on whether its overall estimate of the rate of return is appropriate, and not consider specific parameters or components of the return on equity and debt estimate in isolation. The Commission is concerned that the rules and interpretation of those rules in the current Chapter 6 rate of return framework has led to an undue focus on individual WACC parameter values within the overall estimate of the rate of return.⁴

Most importantly, the draft rule is intended to allow the regulator and the appeal body to focus on whether the overall estimate of the rate of return meets the overall objective for the allowed rate of return, which is closely linked to the NEO, the NGO and the RPP. While the regulator may choose to determine the rate of return by estimating other values to contribute to the allowed rate of return, the Commission considers that assurance that the overall objective is met can only be gained by considering whether the overall rate of return arrived at meets the stated objective.⁵

Each of the statements suggests a consideration of the 'totality' of an NSP's proposal, be it in capex, opex or the rate of return.

The AER welcomes the discretion provided by in the draft rules and the statements on the intended operation of the rules. The AER believes that the ability of the AER to consider capex and opex more holistically and to focus on the overall rate of return addresses the AER's major concerns with the current regulatory framework.

The AER intends to employ a more holistic assessment of capex and opex requirements. This will involve weighing up all available information and relying more on techniques such as benchmarking to inform the AER's assessment of the appropriate level of capex and opex.

Similarly for setting rates of return, the AER will focus on the overall rate of return. As suggested by the AEMC, the AER intends to consider the inter-relationships between the parameters and will not determine the rate of return by 'mechanically summing up' the values for the specific parameters. Instead, the AER will have regard to a number of sources to inform whether an overall rate of return is appropriate.

That said, the AER believes that some clauses should be amended to remove any potential constraints on the ability of the AER to undertake holistic assessments. The AER believes

³ *ibid*, p. 105.

⁴ *ibid*, pp. 40-41.

⁵ *ibid*, p. 33.

that these changes would mean that the rules would better reflect the policy intent expressed in the AEMC's draft determination. These clauses are discussed in Section 4 of this submission.

4 Comments on draft rules

4.1 Capital and operating expenditure forecasts

The rule change proposal argued that the current rules restrict the AER from making an overall assessment of how much expenditure proposed by NSPs is efficient or necessary.

The draft rules address a number of the concerns raised by the AER. They are a clear improvement on the capex and opex assessment framework in the current rules. In particular, the AER has greater scope to reject excessive cost forecasts and substitute the best alternative estimate it can on the basis of the information available. Nonetheless, there are still some improvements that the AER believes should be made to the draft rules to better reflect the AEMC's policy intent.

Constraints on substitute decisions

The AER has previously expressed major concerns with clause 6.12.3(f) and its equivalent clause 6A.13.2(a). These provisions require that the AER's substitute decisions must be based on the NSP's proposal and be amended only to the extent necessary to enable it to be approved under the rules. The draft rule amends clauses 6.12.3(f) and clause 6A.13.2, to make it clear that these clauses do not apply to decisions on the total forecast capex, total forecast opex, and the rate of return. The AER strongly agrees with the AEMC's discussion on the reason for carving out these decisions, in particular where it states that:

The AER should not be limited to assessing a proposal on the basis of a "bottom up", engineering-based approach, and the AER should be free to determine a substitute amount on the basis of the information it has.⁶

However, we note that the AEMC proposes to retain the restrictions in clause 6.12.3(f) for a range of other constituent decisions that may ultimately prevent the intended goal being fully realised.

The AER believes that clauses 6.12.3(f) and 6A.13.2(a) and (b) in the draft rules should be deleted. These provisions may constrain the AER's ability to make overall decisions that are aimed at satisfying the national electricity objective. The reasons are as follows.

Firstly, carving out final decisions on capex, opex and rate of return may not be sufficient. The estimation of a capex or an opex allowance relies on a number of other preliminary decisions on components or inputs within a distribution or transmission determination, such as decisions on cost inputs, demand forecasts, approaches to depreciation and cost escalators, which under the draft rules will still remain subject to the restrictions. The continued application of clauses 6.12.3(f) and 6A 13.2 (a) and (b) to these components may restrict the AER's ability to amend an amount, value or input to the extent necessary to enable that part of the business proposal to be approved in accordance with the rules. At least, it creates the opportunity for confusion and uncertainty around how these provisions may operate within a total determination decision. Similarly, a rate of return decision will depend on the AER making preliminary decisions about the value of imputation credits, the methodology to be

⁶ *ibid*, p. 105.

used to calculate return on debt and the estimation of other appropriate amounts, values or inputs all of which are still subject to clauses 6.12.3(f) and 6A.13.2.

Secondly, it is unclear why the remaining restrictions in clauses 6.12.3(f) and 6A.13.2 remain appropriate. As the AEMC notes that:

*“there have been few strong arguments about the benefits of the clause – and why it should be retained – in respect of capex and opex.”*⁷

The AER considers that similarly, no strong arguments have been put forward to support the retention of the remaining restrictions in clauses 6.12.3(f) and 6A.13.2.

Thirdly, there is no clear rationale for the operation of clauses 6.12.3(f) and 6A.13.2 once it is accepted that capex, opex and rate of return decisions should not be subject to these restrictions. To the extent these clauses oblige the AER to take into account an NSP’s proposal, this is already achieved by clauses 6.10(1)(b)(1), 6.11(1)(b)(1), 6A.12.1(a1)(1) and clause 6A.13.1(a1)(1). Further, administrative law requires the AER to have due regard to all relevant information before it when making decisions. The information in an NSP’s proposal is clearly relevant information. Removing clauses 6.12.3(f) and 6A.13.2 does not mean that the AER would no longer be required to consider the NSP’s proposals. The AER would still be required to assess the proposals and explain why a proposal is not being accepted, and, if the AER decides not to accept the proposal, to explain why it is taking a different approach. The AER’s decisions would remain subject to both merits and judicial review.

Finally, including some limits on the AER’s ability to depart from an NSP’s proposal could restrict the AER’s ability to undertake a holistic assessment. It may limit the AER from taking into account relevant interrelationships and interlinkages between component parts of a distribution or transmission determination. This is crucial in ensuring that the resulting revenues are in the long-term interests of consumers and otherwise meet the national electricity objective.

In summary, the AER considers retaining clauses 6.12.3(f) and 6A.13.2 creates additional risk and uncertainty around the operation and application of the framework, with no perceivable benefit.

Expenditure forecast methodology

The rule change proposal highlighted the concern that NSPs are not restricted in the methodologies they may use to prepare their expenditure forecasts. As a result, the AER often has no notice of the methodologies a business decides to use until the regulatory or revenue proposal is submitted. Within the limited time available in a reset process, significant time and resources may have to be devoted to understanding the forecasting methodology adopted by the NSP. The rule change proposed that consultation on expenditure models would occur as part of the framework and approach paper.

In the draft rules, the AEMC has accepted the proposal that the AER be allowed to develop an expenditure forecast methodology as part of the framework and approach process. NSPs would be required to submit an expenditure forecast which complies with the AER’s methodology as part of their regulatory proposal.

⁷ *ibid*, p. 104.

The AER strongly supports this proposal and believes that it has the potential to improve the effectiveness of the regulatory determination process and facilitate benchmarking. Both of these changes will improve the AER's ability to determine an efficient estimate of forecast costs.

By locking in the expenditure forecast methodology before a revenue proposal is submitted, the AER will be able to focus on the substance of the NSP's application rather than the methodology. This will allow the AER to better and more rigorously scrutinise the NSP's cost forecasts and develop robust substitute forecasts in the event that the NSP's proposals do not reasonably reflect efficient costs.

This potential benefit was also identified by the AEMC in its draft determination:

If the AER and stakeholders do not engage on the expenditure methodologies until after the regulatory proposal is submitted it will take up time generally and, more critically, if the AER prefers a different methodology it may take the NSP some time to re-run its calculations, putting pressure on the rest of the process.⁸

The expenditure forecast methodology will also provide important benefits in terms of benchmarking. It will create further opportunities for the AER to benchmark the cost information which is most relevant to the charges paid by consumers – namely, the regulatory proposals of the NSPs – which have proved challenging in the past.⁹ If NSPs submit cost forecasts which are prepared on a consistent basis, the AER is better able to make comparisons and identify inconsistencies. For instance, if one NSP's view of a particular unit cost is significantly higher than the unit cost submitted by other businesses, the AER would examine the apparent inconsistency in more detail.

Benchmarking inevitably needs to account for the differing characteristics of each network. However, removing unnecessary differences in expenditure forecasts will improve the AER's ability to make comparisons between NSPs. The draft rules allow the AER scope to consider legitimate differences in forecasting methodologies where appropriate. NSPs would be consulted on the form of the standard expenditure forecast methodology and there would be an opportunity for NSPs to deviate from the standard methodology if agreed by the AER as part of the framework and approach consultation. Finally, NSPs have flexibility to prepare alternative cost forecasts, so long as at least one forecast complies with the AER's methodology.

Benchmarking

The draft rules place significant importance on the use of benchmarking. The AER agrees that benchmarking can add significant value in assessing the efficiency of an NSP and determining the appropriate capex or opex allowance.

To this end, the AER welcomes the removal of the expression “the circumstances of the relevant NSP” from the opex and capex criteria in the draft rules. We agree with the AEMC that this clause is likely to inappropriately constrain the AER from undertaking a benchmarking exercise.

⁸ *ibid*, p. 110.

⁹ See, for instance, the Australian Competition Tribunal's decision in relation to Powercor's vegetation management - Application by United Energy Distribution Pty Limited [2012] ACompT 1.

The draft rules also give the AER discretion to determine how it will undertake benchmarking. This approach is sensible as it would be difficult to prescribe in the rules how a benchmarking exercise should be conducted given the variety of potential circumstances. That said, the AEMC's draft determination provides a good indicative list of factors that are likely to be taken into account by the AER when conducting benchmarking analysis.¹⁰

4.2 Capital expenditure incentives

The rule change proposal expressed concern that there are incentives for NSPs to spend more than the capital expenditure allowances set by the AER as part of their regulatory determinations for a regulatory period.

The draft rule provides the following "tools" the AER can apply to provide adequate incentives for NSPs to spend capital expenditure efficiently:

- applying capital expenditure sharing schemes to provide incentives to incur efficient capital expenditure. These are to be designed by the AER;
- undertaking reviews of efficiency of past capital expenditure, including the ability to preclude inefficiently incurred expenditure from being rolled into the RAB. The amount that may be precluded is limited to the amount of any expenditure above the capital expenditure allowance; and
- deciding whether to depreciate the RAB using actual or forecast expenditure.

Capex incentive mechanism

The AER supports the AEMC's proposal to give the AER access to a range of tools that can be used to create incentives for NSPs to undertake efficient capex. We agree that the AER is generally better placed to determine the scope and content of those tools for the purposes of creating incentives for individual NSPs rather than prescribing specific approaches into the rules.

The AER welcomes the AEMC's approach to the development of a capex incentive mechanism, which involves giving the AER flexibility to develop a capex incentive mechanism subject to certain guiding principles. This approach will enable the AER to take account of a range of factors, including the incentives associated with other elements of the regulatory package and the NSP's past expenditure relative to allowances, in designing capex incentives.

The principles proposed by the AEMC provide the AER with flexibility to adapt its approach depending on the relevant circumstances whilst also providing guidance on the key objectives that the AER should seek to achieve. The AER supports the proposed approach, which permits the AER to design a regime which does not meet all of the principles set out in the rules so long as it considers the principles and provides reasons for its decision.

¹⁰ *ibid*, pp. 107-08.

Limited ex post reviews

The draft rules provide for the AER to conduct ex-post capex reviews responds to the AER's concerns about the lack of incentives that currently exist for businesses to only incur efficient capex.

Allowing the AER the ability to preclude inefficiently incurred capex (over the level of the capex allowance) from being rolled into the RAB provides strikes an appropriate balance between providing investment certainty for NSPs and providing incentives to invest efficiently. NSPs would have flexibility to spend in excess of allowances when necessary whilst retaining incentives to incur only efficient capex.

The AER also supports the requirement for it to make a statement on the efficiency of capex going into the RAB in its draft and final determination for each NSP. Such a statement has the potential to provide information to all stakeholders on the efficiency of the NSP and may be a useful input into the analysis of capex allowances for the next regulatory period.

Uncertainty regime

The draft rules implement the rule change proposal with respect to capex reopeners and contingent projects. The AER supports the AEMC's approach as it provides an additional option in the regulatory toolbox, and the costs of implementation are low.

We also propose a further refinement in relation to pass through materiality thresholds. The draft rules reflect the rule change proposal to amend the materiality threshold in Chapter 6 to at least 1 per cent of a distribution NSP's annual revenue requirement, in line with threshold in Chapter 6A.

Since the rule change proposal was submitted, the AER has considered a group of pass through requests where the amount at stake was very close to the proposed threshold. As a result of these developments, the AER has refined its position in relation pass through materiality thresholds.

The pass through mechanism is designed to allow the businesses to recover the costs associated with a significant event that was outside of its control. However, the pass through mechanism is not designed to correct for the normal immaterial variations from forecast that are to be expected over the course of the five-year regulatory period. The potential for these fluctuations is recognised in setting the rate of return and in setting ex-ante expenditure allowances.

At 1 per cent of the NSP's annual revenue requirement, the pass through materiality threshold is very low. It may be appropriate to allow pass throughs that are only 1 per cent of the annual revenue requirement in some circumstances (for instance, where a cost has been forced on the NSP via a regulatory change and the scale of the cost is outside the control of the business). However, this threshold has the potential to also capture normal immaterial variations.

The AER believes that the materiality threshold should be a *necessary but not sufficient* condition for granting of a pass through. The AER should have discretion to determine whether or not to allow a pass through amount, having regard to the revenue and pricing principles (RPP) and the ability of the regulatory determination to contribute to the achievement of the national electricity objective (NEO).

This could be achieved by amending clauses 6.6.1(j) and 6A.7.3(j) to require the AER to take into account whether to not make a pass through adjustment would jeopardise the ability of the relevant regulatory determination to contribute to the achievement of the NEO and be consistent with the RPP.

4.3 Rate of return issues

The rule change proposal raised concerns that the framework for determining the rate of return was inconsistent across electricity transmission, electricity distribution and gas. The rule change proposal highlighted a concern that a parameter by parameter approach to setting the rate of return was moving the rate of return estimate away from one that was efficient.

The draft rules sets out an approach to setting the rate of return that is common to electricity transmission, electricity distribution and gas. The approach requires the AER to make the best possible estimate of the rate of return at the time a regulatory determination is made, consistent with an overall rate of return objective. This effectively means that the rate of return is set on a 'determination by determination' basis. This is supplemented by a requirement to produce rate of return guidelines at least every three years.

The AER supports the approach adopted in the draft rules. The AER believes that the approach in the draft rules allows for both consistency and flexibility in rate of return determinations across the different industry sectors.

The approach outlined in the draft rules promotes consistency by applying a single framework for determining the rate of return for electricity and gas network service providers. This minimises the risk of distortions in capital allocation and investment decisions between the different industry sectors. If different rules for setting the rate of return apply across the different sectors then there is a risk investment will be skewed towards sectors which produce the highest rates of return. This type of situation is undesirable as resources are not being directed to their most efficient use.

While promoting consistency the draft rules also provide flexibility to respond to market developments. An approach of setting the rate of return on a determination by determination basis ensures that the AER is better able to respond to changed financial market conditions. In so doing, it ensures that rate of return decisions are more reflective of prevailing financial market conditions.

The AER agrees with the rate of return objective that the AEMC has outlined in the draft rules. The AER considers that it is essential that the rate of return framework be based around the concept of efficiency and only allow the recovery of benchmark efficient financing costs.

The AER also strongly supports the requirement to develop a rate of return guideline at least every three years. This enables all stakeholders, including consumers and NSPs, the opportunity to contribute to the development of the AER's approach to the rate of return. This also promotes significant transparency around the AER's approach for determining the rate of return. The AER agrees with the AEMC that the development of these guidelines will also provide an appropriate forum in which to discuss approaches to estimating the return on debt.

Prescription of rate of return provisions

As discussed above, the AER supports the AEMC's policy intent to focus consideration on whether the overall rate reflects an overall objective that corresponds to the efficient financing costs of a benchmark efficient entity with a similar degree and nature of risk.

However, the AER is concerned that the draft rules do not fully achieve this objective.

Rule 87 of the National Gas Rules sets an overall objective for the rate of return in paragraph 87(1) but then prescribes in rule 87(2) how the rate of return is to be determined. In the ATCO decision¹¹, the Tribunal found that rule 87 of the NGR should be interpreted as follows:

- Rule 87(1) describes the objective in determining the WACC but does not prescribe how the objective is to be achieved.
- Rule 87(2) describes how the objective is to be achieved; that it must be determined using a well accepted approach, such as the WACC, and through a well accepted financial model, such as the CAPM.
- Rule 87(1) informs the selection of appropriate input parameters to be used in the well accepted approach and well accepted financial model but if the requirements of rule 87(2) are met then it follows, as a matter of law, that the general objective has been met.

The draft rules on rate of return may use different terminology to rule 87 but the draft rules still follow the same basic pattern of rule 87. There is a general provision (see for example clause 6.5.2(b)) that sets an overall objective. This is, however, followed by other clauses that set prescriptive requirements. For example, in the draft rules, clause 6.5.2(c)(1) states that the rate of return "must be determined":

...as a weighted average of the return on equity for the regulatory control period in which that regulatory year occurs (as estimated under paragraph (e)) and the return on debt for that regulatory year (as estimated under paragraph (f)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed by an efficiently financed benchmark efficient entity with a similar nature and degree of risk as that which applies to the distribution network service provider in respect of the provision of standard control services.¹²

This clause could be interpreted as requiring the WACC approach to be followed and for return on equity and return on debt to be determined separately, and then "mechanistically" brought together via a gearing ratio that meets certain requirements to determine the overall rate of return.¹³

¹¹ *Application by WA Gas Network Pty Ltd (No 3)* [2012] ACompT 12, paragraphs 61-66; see also *Application by DBNGP (WA) Transmission Pty Ltd (No 3)* [2012] ACompT 14, paragraphs 80-84, 100-103.

¹² The AEMC has proposed equivalent draft rules for the chapter 6A and the NGR.

¹³ The rate of return objective might be best furthered by determining the cost of equity and cost of debt separately in this manner. The point the AER makes is that this approach should not be mandated by the rules. Rather, it should be a matter for the AER to determine in consultation with relevant stakeholders in order to achieve the overall objective.

There is a similar tension between the goal of setting an overall objective when estimating a rate of return and the inclusion of specific (though partly overlapping) rule requirements for separately determining the cost of equity and cost of debt. For example, the option of adopting annual updates to the cost of debt but not to the cost of equity is one such difference between the cost of equity requirements and cost of debt requirements and may restrict the ability to set an overall rate of return that meets a particular objective.

To resolve this tension the AEMC could:

- Maintain that the rate of return must be estimated in a way that is consistent with the allowed rate of return objective.
- Maintain that the rate of return must be determined on a nominal post tax basis.
- Maintain the process requirements around the development of the rate of return guidelines.
- Remove the other criteria and factors in the draft rules that prescribe, as fixed rules, how the objective is to be determined. The draft rules could recast such criteria as matters the AER must have regard to when estimating the rate of return. This would mean that the AER would be required to turn its mind to each of these criteria when estimating the rate of return, but it would also mean that the ultimate legal requirement under the rules is to set a rate of return that meets an overall objective.

4.4 Regulatory process

The rule change proposal highlighted that the consultation procedures in the current rules can be improved to allow stakeholders to more effectively engage in the process.

The AER recognises that the draft rules incorporates a number of amendments to the regulatory determination process which seek to address issues that have been raised by the AER and consumer representatives. The AER welcomes the AEMC's focus on new arrangements that will enhance consumers' participation in the regulatory process and that will improve opportunities for appropriate scrutiny of regulatory proposals.

Consumer engagement

The AER believes that the consumer engagement initiatives outlined in the draft rules represent a significant improvement over the current arrangements. In particular the AER welcomes the requirement for NSPs to outline in their proposals the extent to which they have engaged with electricity users in the development of their spending proposals, as well as the need for NSPs to provide an overview paper for consumers. Both initiatives have the potential to facilitate improved consumer understanding of the issues being considered in a regulatory determination.

In some areas, the initiatives proposed by the AEMC are more comprehensive than those proposed in the rule change proposal. In particular, the AER welcomes the AEMC's proposal to incorporate the extent of consumer engagement into the capital and operating expenditure factors. This draft rule means that the AER can consider the extent to which businesses have engaged with consumers in setting capital and operating expenditure allowances. This will

create an appropriate incentive for NSPs to genuinely engage with consumers and encourages a greater focus by NSPs on providing services that are valued by consumers.

The requirement for the AER to publish a benchmarking report on the relative efficiency of NSPs will also provide consumers with information that they can use to better engage with NSPs and the regulatory determination process.

Timeframes for decision making and consultation

The AER also welcomes the incorporation of additional time in the process to allow for an issues paper stage and more consultation early in the process. This would also allow more time for stakeholders to prepare submissions and for a cross submissions stage if required. The AER is pleased that the cross submissions stage outlined in the draft rule would be at the instigation of the AER and could be used to consult on specific issues that may arise during the process which may not otherwise have been subject to consultation. These limitations are important so as to minimise the opportunity for NSPs or other parties to use the cross submissions stage to submit information which should properly have been submitted earlier in the process.

The AER also welcomes the arrangements to extend timeframes for decision making under the 'uncertainty regime'.

Late or confidential information

Also included in the draft rules are arrangements designed to discourage NSPs from strategically withholding key information until the final stages of the review process and from seeking confidential treatment for information which is not genuinely confidential. The AER would be required to publish a notice informing stakeholders when NSPs submit confidential or late information.

In relation to dealing with confidential information, the AER notes that the proposed confidentiality guidelines may be a useful opportunity for the AER to outline its expectations with regards to confidentiality claims.

Framework and approach

The AER also believes that the draft rules provide for a more effective framework and approach (F&A) stage in both transmission and distribution. The optional F&A process removes the need to reconsider issues that have been dealt with previously and do not require reconsideration, thereby potentially streamlining the F&A stage.

The F&A process also provides an important opportunity to settle a number of issues prior to the regulatory proposal being submitted. A key example, as discussed earlier, is the ability for the AER to consult and set out the expenditure forecast methodology in the F&A stage that would be needed to be used by the NSP in its proposal. Settling such issues early in the process is expected to create greater transparency and will improve opportunities for scrutiny of NSP proposals by other stakeholders and the AER.