

Submission to the Australian Energy Markets Commission

Re: Economic Regulation of Transmission Services on the Propose-Respond Model



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Distribution

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Key Messages from the UED Submission

That the AEMC should maintain its Draft recommendations on the limited propose-respond models with the reasonableness criteria on the basis that the:

- **AGS has failed to make a case for a change in the decision criteria as they have neglected the national economic policy framework as agreed by Australian Governments;**
- **It is illogical to argue that a regulator faced with a range of "reasonable" possibilities can possibly choose the "best" one when the extent and shape of the distribution of "reasonable" estimates cannot be known with any certainty;**
- **The Productivity Commission has confirmed that a regulator does not have the certainty to produce a 'best' estimate; and**
- **The AEMC model is the best practice for a stable predictable regime as it is based on a model which will reduce gaming as it is based on a model to ensure logical consistency.**

1 Introduction

United Energy Distribution (UED) fully supports the Australian Energy Management Commission's (AEMC) proposal to introduce a limited propose-respond model for forward looking estimates of capital and operating expenditure.

In this submission UED supports the AEMC approach on the basis that:

- the propose-respond model best fits the uncertainty of the regulated arrangements given the need for regulated businesses to forecast five years out even though asset lives are substantially longer;
- the propose-respond model with its test of reasonableness is best regulatory practice as it is based on the principle that the costs of under-investment are much greater than the costs of over-investment; and;¹
- the requirements of the AEMC propose-respond model encourage regulated businesses to only make reasonable proposals whereas a consider-determine model would encourage gaming and ambit claims.

¹ This has been supported by the Productivity Commission in its Inquiries into the National Access Regime and the Review of the National Gas Access Regime and it forms the background to the pricing principles in the NEL which use the term that regulated prices are "at least sufficient to meet the efficient costs of providing access". The principle is also supported by the Queensland Competition Authority and the New Zealand Government as well as key academics.

In the first instance UED provides answers to the questions raised by the AEMC before expanding on the issues considered. The submission will then deal with concerns with the AGS advice before explaining the correctness of the propose-respond model, as a matter of policy, as best regulatory practice and as consistent with sound economic analysis.

The AEMC state that they are aware that at least 3 questions have been raised by interested parties in relation to the draft wording of the revenue rules. UED's responses to these questions are included below in bold text:

- a. whether they impose an "onus of proof" on the TNSP or the AER;
 - **Paragraph 61 of the AGS advice states that no onus of proof from the proposed Rule is likely to be read into the Rules, not for the TNSP or the AER. UED agrees with this conclusion and notes that administrative decision making is not about the proof of facts, but rather about the exercise of discretion.**
- b. whether it would be necessary for the AER to form a view that a TNSP's proposal was "unreasonable" before it could reject it;
 - **Yes, UED submits that requirement is a necessary condition of the limited propose-respond model supported by the AEMC as set out at pages 51 and 52 of the AMEC Draft Decision.**
 - **Paragraph 61 of the AGS advice states that the AER must simply make a decision on the factors and set out its reasons for that decision.**
- c. whether those rules would operate to create a presumption in favour of acceptance of the TNSP's proposed forecast expenditure, if the AER was satisfied that the proposal met the criteria contained in the revenue rules.
 - **UED considers that the usage of the term "presumption", given some emphasis by the Expert Panel, is unfortunate as it is suggestive of issues relevant to an onus of proof – presumptions, at law, are about proof of facts. Upon proof of one fact, another fact may/must be presumed. Regulatory decision making is not about proof of facts but rather about the exercise of discretion and the use of the language of 'presumption' and 'onus of proof', in the context of the debate about the regulatory decision making standard, has tended to carry with it a negative connotation of there being an unsupportable burden placed upon the regulator;**
 - **UED submits the AEMC ought to stand firm in the face of the use of this language to influence it. This language is not appropriate for an assessment of the benefits or otherwise of an administrative decision making standard.**
 - **Quite properly, the AEMC's Draft Rule simply provides a decision making standard based around reasonableness, provides guidance to the AER in setting out a number of factors to consider and requires the AER to give reasons for its decision. In these reasons the AER must establish why the TNSP's proposal is "reasonable" or "not reasonable".**

The AEMC also invited further submissions and comments from interested parties in relation to these matters and in particular, whether the Rules should provide that:

- a. a TNSP's proposal must be accepted if the AER is satisfied that the proposal for forecast expenditure satisfies the criteria in the Rules; or
- b. the AER should have a residual discretion to substitute its own reasonable estimate of forecast expenditure in those circumstances.
- **UED considers that the Draft Rule need not be altered. The TNSPs proposal must be accepted if it is a 'reasonable estimate' having regard to the guidance provided by the criteria; and**
- **There is no reason to revert to the consider-determine model that is embodied in an alternative proposal for the AER to have a residual discretion to substitute its own 'reasonable estimate', or for that matter its own 'best estimate', of forecast expenditure. The policy support for this view is presented below.**

2 Some Problems with the AGS Advice

UED is concerned that the Australian Government Solicitor (AGS) legal advice lacks any understanding of the competition policy issues that sit behind regulator decision models. For example the AGS advice hints at the economic policy background of the propose-respond model in Para 52 where they state:

The NEL objective and the pricing principles may influence the resolution of uncertainty with regard to a service provider's estimates. We note that these in turn also contain competing objectives and considerations. However, generally the pricing principles place considerable weight on protecting the interests of service providers. The pricing principles in particular would therefore favour the view that a broad range of proposals from a service provider will be within the bounds of a reasonable estimate.

What the AGS fails to note is that these pricing principles result from a settled national policy position, agreed after long debate and consideration of the National Third Party Access Regime in Part IIIA of the Trade Practices Act as well the National Gas Access Regime, and that these principles would support a propose-respond model with "reasonable estimates" is the natural outworking of that agreed national policy position. Not seeming to have regard to this settled national policy, the AGS then argue in Paragraph 68, without reference to the pricing principles, that:

The AER's discretion either to accept a total as a best estimate, or impose a best estimate, will result in more symmetrical review rights for users and service providers as opposed to a test based on a reasonable estimate.

So the AGS advice recognises that the pricing principles favour the service provider, but the decision criteria they seem to prefer is inconsistent with this policy position. This is an illogical position and should be discounted by the AEMC.

The conclusion by the AGS in Paragraph 68 flowed from a view expressed in Paragraph 60 that:

The situation where the AER accepts a generous proposal from a service provider also needs to be considered. Users may wish to challenge that the AER's decision. In such a case, the Tribunal may focus on distinguishing a 'reasonable' estimate, from the absurd, irrational or ridiculous, if the AER has formed a *bona fide* view of the total. The current limited merits review framework, including the threat of indemnity costs, would make such review difficult for any applicant.

However, this would also be the case if the AER made a generous decision under the "best estimate" framework as a user would still have a difficult task to establish the decision was not the "best estimate".

Perhaps more importantly, though, when read together Paragraphs 60 and 68 amount to the only justification for moving to the consider-determine framework of a "best estimate". This is a very shallow argument by the AGS in the face of the extensive public policy debate that has been had around regulatory decision making standards, including the full and proper consultation carried out by the AEMC to date, and could not possibly support a shift in the AEMC's position even if it were correct.

But it is not correct. There is no asymmetry in appeal rights. A TNSP wishing to challenge a decision of the AER that an estimate it put forward was not reasonable would face exactly the same challenges as a User. In both cases the Tribunal would focus on the distinction between reasonable and not reasonable and may rely upon a number of paraphrases of meaning.

The limited, and incorrect, reasoning to support a conclusion of asymmetry in appeal rights and the lack of any reasoning at all to support the conclusion that a "best estimate" test is more symmetrical also weigh heavily against this argument swaying the AEMC from its Draft Decision.

Finally, if there is an issue arising in the merit review framework, it should, be resolved in that forum, not in a decision regarding the regulatory decision making standard.

A further example of a lack of reasoning to support an apparently important conclusion is found in Paragraph 53:

The reasonable estimate decision framework based on the twelve factors does enable the AER to reject total forecasts which are not based upon reason, or exceed the limits prescribed by reason, after critically analysing all the evidence. However, the use of the 'reasonable estimate' test, uncertainty in forecasting, the existing case law in *Gasnet* and *Telstra* and the role of the pricing principles in resolving conflict, will result in the AER being required to accept a range of forecasts higher than those it would determine as the most appropriate or best estimate.

In this paragraph the AGS advances the case that, despite the twelve factors which the AEMC has determined will limit ambit claims, returns to TNSPs will rise. This conclusion is unsupported by sufficient reasoning - as there are a range of possible reasonable estimates, how can any regulator be sure of the mid-point, and how can the AGS know of the likely reaction of the Australian Energy Regulator (AER) to its task. The AER can deal with such circumstances by the development of appropriate guidelines and with extensive information gathering powers. It simply does not follow conclusively, and seems not to

follow from the preceding paragraphs of the advice, that the use of the 'reasonable estimate' test **will result** in the AER being required to accept a range of forecasts higher than those it would determine as the most appropriate or best estimate.

On this basis UED submits that the AGS has failed to establish a case for the AEMC to move from its Draft position on the limited propose-respond model and the reasonable estimates.

3 The Issue of the AEMC Propose-Respond Model for Capex and Opex

The AEMC has proposed that a proposal by a regulated entity may only be classed as reasonable if it covers the following areas in terms of "reasonableness"

"The following criteria have been specified in the Draft Rule 104 as matters to be taken into account by the regulator in coming to a decision:

- the information included in the Revenue Proposal;
- the need to comply with regulatory obligations;
- submissions from interested parties;
- information published by the AER prior to decisions regarding the Revenue Proposal;
- the actual and expected operating and capital expenditure;
- the extent that forecasts are referable to arrangements with a person other than the provider that might not be on arm's length terms;
- reasonable estimates of an efficient benchmark TNSP;
- the reasonableness of the demand forecasts;
- the relative prices of operating and capital inputs that prevail at the time for that particular TNSP;
- the efficiency of substitution possibilities between operating and capital expenditure that may exist for that particular TNSP;
- whether the total labour costs are consistent with the incentives provided by the service performance incentives scheme; and
- whether the forecast expenditure includes amounts relating to a project that should more appropriately be included as a contingent project." (p. 53.)

The Issue of Gaming and the Regulatory Model

The AEMC proposal is far in excess of a simple propose-respond model and requires the exercise to determine a reasonable case for demand forecasts, operational and capital costs and revenue forecasts, relative prices, capital-labour substitution and service improvements. Such an approach will ensure that the regulated business puts in a logically consistent reasonable proposal that attempts to meet the requirements of the Rules as if it does not its subject to the regulator's estimates.

In a consider-determine model the natural bias of such models is to encourage gaming as the regulated entity does not know how much the regulator will reduce revenue and hence is encouraged to submit ambit claims. In comparison the AEMC model of propose-respond will eliminate this problem as the need for “reasonable” position on each of the twelve factors will ensure a “reasonable” submission due to the need for logical consistency. It is also important to remember that regulatory decisions are about more than prices as they include the whole price and service offering.

Under these conditions a service offering requires a propose-respond model as it is unique to the local environment and the regulator may not be aware of such differences under a consider-determine model which could involve significant errors.

However, the Expert Panel has argued that:

There is little doubt that a propose-respond model (particularly in the form proposed by the Productivity Commission) would over time lead to a systematic increase in the returns to regulated entities relative to the receive-determine model. This is because it seems improbable that, given the choice of proposing an estimate within a range, the regulated entity will opt for other than its estimate of the upper end of the range. By contrast, it might be argued that under a consider-decide model the regulator will be inclined to aim at an estimate of the central point in the range. (Page. 78)

The Expert Panel point out that there is no evidence of a systematic advance in returns in the few decisions that have been under the propose-respond rule. UED does not consider that this will result due to the twelve AEMC factors that require logical consistency and the desire for service provider to have its submission to be classed as “reasonable” so as not to be subject to the risks of regulatory errors by having the submission classed as unreasonable.

UED therefore supports the AEMC position as follows:

However, the Commission considers that any uncertainty of interpretation of the reasonable estimate criterion will be reduced substantially by the requirement for the AER to have regard to the criteria and evidentiary material specified in the Rules. It notes in this regard that the AER has commented that the list of factors to be considered provides an appropriate basis for the assessment of expenditure forecasts and its concern is with the decision rule itself.

Turning to the Expert Panel's concern about incentives for strategic behaviour, such incentives are a reality in a regulatory process the purpose of which is to determine the future revenue and prices of regulated businesses and thus their future profitability and shareholder value. In this situation, regulated businesses will have an incentive to ‘talk up’ the forecasts of expenditure required to provide the service under any decision criterion.

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

In particular, the AER's capacity to deal with exaggerated proposals will be strengthened by the requirement for the TNSPs to make a complete proposal (in conformity with AER guidelines) including information and evidence consistent with the assessment criteria in support of their expenditure forecasts. The Commission also

considers that the decision making process to be followed by the AER in assessing the expenditure forecasts is more likely to provide an incentive to submit well documented and supported expenditure forecasts rather than to submit forecasts that are grossly exaggerated. That is, TNSPs are likely to see the benefits of seeking AER acceptance of well supported forecasts of expenditure as outweighing those resulting from ambit claim forecasts with the associated risk of the AER rejecting excessive and poorly supported expenditure forecasts and replacing them with its own forecast. (p.52)

4 Is the Subject Matter Uncertain?

In the regulation of utilities there are substantial uncertainties covering costs and revenues and these are outlined below.

Costs

In terms of costs there are a number of uncertainties over the access pricing period including the;

- possible variations in costs during the construction phase (for example, the costs of procuring materials such as steel);
- operational risks (for example, changes to environmental, safety and technical requirements);
- uncertainties about productivity changes;
- uncertainties about technological changes;
- changes in weather pattern which can affect cost through extreme weather patterns;
- potential changes to labour rates from skills shortages;
- possible constraints on hiring skilled labour due to skill shortages; and
- potential changes in the trade offs between labour and capital.

Revenues

In terms of revenues there are also a number of uncertainties over the access pricing period including the;

- uncertainty about future market outcomes (for example, the possibility that demand for a facility will abate due to the emergence of changes in customer circumstances such as energy saving technology);
- uncertainty about future technology developments. Given the scale of investment in essential infrastructure, and the fact that, once in place, the assets are 'sunk' with few alternative uses, the risks associated with energy investments are especially high; and
- uncertainty about weather patterns as they affect demand

In discussing the task of regulators the Productivity Commission has concluded that they have an impossible task:

Regulators must operate with limited information and imperfect regulatory tools. This implies that precise delineation after the event between genuine monopoly rents and balancing upside profits on successful projects will be well nigh impossible. Accordingly, even an 'unbiased' regulator could sometimes allow a service provider to retain an element of rent, and sometimes truncate balancing upside profits. (As discussed in section 4.5, service providers argued that a range of factors are likely to encourage regulators to err on the side of users.) (p.82, Inquiry into National Access Regime)

While the above analysis refers to the gas sector the issues are common with electricity in light of the regulatory models requiring five yearly forecasts and also utilising the Building Blocks model.

5 The Decision Model for Regulation

To determine a "best" estimate a regulator would have to assume a distribution of "reasonable" estimates and choose the mid-point as the "best" estimate, as suggested by the Expert Panel in the previous section.

However, for the regulator to determine what the "best" estimate is they will have to understand the complete distribution of "reasonable" estimates and choose the "best" one or the mid-point. The same problem would arise with the alternative decision criteria of 'a best estimate arrived at on a reasonable basis' as the estimate of a "best" estimate would also be required which is not possible give the above discussion.

If the distribution of these "reasonable" estimates are normally distributed the regulator may have some chance of estimating the distribution. However, there is no apriori reason why the distribution should be normal especially if there are weather forecasts as part of the volume forecasts. Hence if a regulator cannot know the bounds of the distribution or its shape then how can a regulator logically determine the "best" estimate from a range of "reasonable" estimates?

The Australian Concise Oxford Dictionary states that the definition of "reasonable" as "having sound judgement" and is "not greatly less or more than might be expected". UED consider that the decision criteria of "not greatly more or less than might be expected" is a sound and fair decision criteria

UED considers that the AEMC model will provide a stable, predictable regulatory regime for assets which are long lived and sunk. Business makes decisions on the long term and given the range of uncertainties discussed above a model of regulation is required which reduces the level of regulatory prescription and recognises that the "reasonable" basis reflects the reality of the circumstances.

Recommendation

Given this conclusion and the arguments in this submission UED considers it preferable for the AEMC to maintain the "reasonable" approach for capex and opex and the limited propose-respond model as more likely to produce better regulatory outcomes.