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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

cc: Richard Khoe

8 December 2011

Dear John,

Submission on AEMC consultation paper (ERC 0134)

Australian Paper (AP) welcomes the opportunity to make a submission to the AEMC's Consultation Paper on the changes to Chapters 6 & 6A proposed by the Australian Energy Regulator (AER).

AP manufactures both uncoated printing & writing papers (including copy paper, envelope paper, scholastic paper, printing paper and security papers) and packaging & industrial papers at its Maryvale mill in Latrobe Valley. The Maryvale mill also provides materials (paper pulp) to AP's small specialty printing and writing papers mill in Shoalhaven NSW. Australian Office, a division wholly owned by AP, also manufactures envelopes and other paper-based stationery products in Australia.
Outside of mining and agriculture, the paper industry is one of Australia's few major regionally based industries.

AP also imports coated paper from its parent company in Japan for resale in Australia and hopes in the future to expand its Latrobe Valley manufacturing facilities to produce this paper in Victoria if this becomes commercially viable.

The Pulp & Paper industry is highly energy intensive and whilst AP produces 55% of its energy requirements from renewable sources at its Maryvale Mill facility, the 45% that we do purchase makes us one of the largest energy purchasers in Victoria. As such, our business is very susceptible to ever increasing energy prices.

Australian Paper would encourage the AEMC to review not only Chapters 6 & 6A but also reconsider the Electricity Rules in general and their delivery, or non-delivery as the case may be, of the National Electricity Objective.

Yours sincerely,

B Green

Brian Green
Energy & Regulatory Reporting Manager
Australian Paper

SUMMARY

Transporting electricity on the transmission and distribution networks in the National Electricity Market (NEM) is a significant, capital intensive, industry. For the typical electricity user, the charge for transporting electricity to its point of use is more than 50% of their electricity bill. This charge (and its proportion of the final electricity bill) has risen dramatically over the last five years and will continue to do so for the next five years following recent AER regulatory decisions.

Network Service Providers (NSPs) are a monopoly business and consumers rely upon the AER and AEMC to ensure that the costs that these businesses should be allowed to charge their captive customers are reasonable efficient costs. Australian Paper has the view that normal commercial risk and prudent capex management is not being exercised by the NSPs nor is it being enforced by the AER. Typically this risk is foisted upon consumers and, it would appear, NSPs expect this as of right, and are outraged by suggestions to the contrary.

Our view is that this culture of entitlement has engendered lax cost control amongst most NSPs and rent seeking amongst all of them. In so many respects, the protections provided to the NSPs through the system of economic regulation could not be more different from the relentless competition that shapes ordinary companies in delivering the essential goods and services that our customers want. If the intent of the system of economic regulation of NSPs is to mimic the disciplines arising in competitive markets, it must surely be recognised that outcomes have fallen far short of intentions.

Is there a problem to be solved?

The NSPs have suggested that to the extent that there is a problem it is that the regulators have failed to understand their businesses, and have been prone to error. On this logic, NSPs are suggesting that even more generous regulatory settlements should have been made.

The NSPs have failed to respond to the evidence in the public domain (some of which is summarised in this submission) that rising demand, ageing assets and historic underinvestment does not adequately explain rising expenditure. Some NSPs have responded to rising demand and have replaced ageing assets at much lower cost than

others, and there is little evidence to support the conjecture of systematic underinvestment in the past.

On the contrary, significant institutions and individuals are persuaded of the existence of a problem (including the Australian Energy Regulator, the Independent Pricing and Administrative Tribunal, the Garnaut Review, Professor Parry, the Tamberlin Review and the Parry-Duffy Report). If NSPs assert that of all these individuals and institutions are wrong they must produce the evidence for this, not just rely on hollow assertion as is currently the case, at least in the public domain.

Comment on the AER's proposals

The AER has proposed changes to the electricity Rules that, for the most part, we support. In particular we support the changes to restore the onus of proof on NSPs to justify their proposals (rather than on the regulator to refute them) and removing the presumption in favour of NSPs' proposals that the AER is required to observe.

However, whilst AP supports changes to the Rules in these areas, in a more general sense, we suggest that prescription is not *necessarily* in NSPs interests, and neither is discretion *necessarily* in consumers' interests. For example, giving more discretion to a regulator that was inclined towards NSPs might be expected to result in decisions more favourable to NSPs, than would be the case if there were prescriptive rules that restricted the regulator's ability to do this. As such, we suggest that describing the problem as a dichotomy between prescription and discretion is not useful. The problem is better described as poorly-specified prescription.

AP also supports the AER's proposal to strengthen the incentive on NSPs not to overspend their regulatory allowances. However we are less attracted to the AER's proposals to extend the "contingent project" and "re-opener" provisions (that currently apply to TNSPs) to DNSPs. These additional provisions weaken the capital expenditure disciplines (why bother to constrain expenditure if you can just apply to the AER for a contingent project or cost pass-through, or indeed, apply to re-open the whole decision.

Furthermore these mechanisms create moral hazard, encourage cost shifting and reward rent-seeking. The philosophy underlying price cap regulation is that NSPs will be set a reasonable expenditure allowance (which users would be required to pay) on the clear understanding that the future is uncertain and hence the efficient level of expenditure is uncertain. It is for the NSPs to discover the efficient level of expenditure in response to incentives that allow them to increase their profits if they reduce expenditure below regulatory allowances. The price cap regulatory approach recognises that much of an NSP's expenditure program is fungible and that what is lost on the swings will be gained on the roundabouts.

The AER's proposals undermine the philosophy of price cap regulation by providing many other ways in which NSPs may recover expenditure from consumers, other than through the main price control. Presumably the AER was minded to bolster these various forms of cost pass-through on the basis that if it did not do this, NSPs might not be able to meet their reliability targets if future events during the regulatory control period turned out to be less benign than expected. But the arrangements that the AER has proposed are at the expense of weaker cost control and hence higher prices to all energy users.

There are other ways that the AER might ameliorate its concern about reliability of service provision by, for example, strengthening service standard incentives so that NSPs suffer material financial losses if they fail to meet reliability performance standards.

If the AEMC is minded to extend the contingent project and re-openers to DNSPs as the AER has proposed, we suggest that the AEMC might consider protections against cost-shifting, rent seeking and moral hazard. This might be achieved through:

- Some form of "excess" so that NSPs are required to absorb the first $x millions of any claim before costs associated with contingent expenditure; pass-throughs or re-openers are reflected in regulated charges;
- Restricting the ability of an NSP to apply for a re-opener or contingent project only if the total capex and opex during the regulatory period has exceeded the allowed expenditure for the period.
- Requiring the NSPs to demonstrate that substitution of projects (as any other business would be obliged to do) had been considered and a detailed report being provided showing why this approach was not a viable option.

On the treatment of the Weighted Average Cost of Capital (WACC), the AER has proposed changes, the effect of which is to leave all aspects of the determination of the WACC to the AER, through periodic reviews that the AER will conduct.

Whilst AP agrees with parts of this proposal, we specifically do not agree that the determination of the return on debt should be part of the AER's WACC review. The reasons for this are set out in the Energy Users Rule Change Committee proposal document and AP fully endorses and commends that document to the AEMC.

AP also does not agree that the specification of the risk free rate should be left to the AER – while AP disagrees with the current specification of the risk free rate in the Rules, the fact that it remains in the Rules means than it is subject to correction through proposals that energy users (or others) could make. Energy users would not have the same opportunity to propose changes to the calculation of the risk free rate if it was simply left to the AER's determination.

AP agrees with the AER's proposal to eliminate the "persuasive evidence" clause from Chapter 6 – through this DNSPs have been able to appeal AER WACC decisions on the averaging period for the risk free rate and Gamma. Both appeals have been disastrous for consumers and AP is concerned that the Australian Competition Tribunal was not adequately equipped to deal with these appeals and failed to understand their effect on electricity prices.

Finally the AER has proposed various procedural changes and also changes to the weight it will place on confidential information provided by NSPs. The case for these changes is well made and we support the AER's proposals on this.

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1 Introduction

This document is a submission from Australian Paper to the Australian Energy Market Commission's (AEMC's) Consultation Paper on the AER's rule change proposals.

The submission comments on the Australian Energy Regulator's (AER's) proposals to change the Rules and also reflects on discussion and comments made during the AEMC's briefing at the Brisbane Forum on 23 November 2011.

Transporting electricity on the transmission and distribution networks in the National Electricity Market (NEM) is a significant, capital intensive, industry. In 2011 network service providers operating in the NEM will recover regulated revenues of around $10bn on regulated assets valued at $64bn. Government owned NSPs in Queensland, New South Wales and Tasmania account for around 75% of these regulated assets and serve around 60% of the nine million connections in the NEM, with the remaining services provided by privately owned NSPs in Victoria and South Australia.

For the typical electricity user, the charge for transporting electricity to its point of use is more than 50% of their electricity bill. This charge (and its proportion of the final electricity bill) has risen dramatically over the last five years and will continue to do so for the next five years following recent AER price/revenue control decisions. These rising charges have had a notable impact on inflation in many States. Outcomes in such a large element of the electricity industry also have a big impact on the productivity of the Australian economy and the welfare of its people.

Network Service Providers (NSPs) are a monopoly business and consumers rely upon the AER and AEMC to ensure that the costs that these businesses should be allowed to charge their captive customers are reasonable efficient costs. Australian Paper has the view that normal commercial risk and prudent capex management is not being exercised by the NSPs nor is it being enforced by the AER. Typically this risk is foisted upon consumers and, it would appear, NSPs expect this as of right, and are outraged by suggestions to the contrary.

When NSPs fail to provide a reliable supply (and this is infrequently the case) they are quick to point the finger at the regulator that, they say, has starved them of funds.

Seldom if ever do the NSPs admit that, perhaps, there is more that they could do to manage their businesses better.

Our assessment is that this culture of entitlement has engendered lax cost control amongst most NSPs and rent seeking amongst all of them. In so many respects, the protections provided to the NSPs through the system of economic regulation could not be more different from the relentless competition that shapes normal companies in delivering the essential goods and services that their customers want. If the intent of the system of economic regulation of NSPs is to mimic the disciplines arising in competitive markets, it must surely be recognised that outcomes have fallen far short of intentions.

Energy users – large and small – are paying the price for the consequential inefficiency. This jeopardises the sustainability of our businesses and puts the jobs of our employees at risk. It has gone on for too long and must now be properly addressed.

In his opening remarks at the Brisbane Forum, John Pierce suggested that it is necessary to be realistic about the extent to which changes to the Rules can affect electricity prices. We recognise this. Regulatory design – for which the AEMC is accountable - is one part of the problem. Ownership and regulatory conduct also matter.

Notwithstanding this, regulatory design has a significant impact on the allocation of costs and risks between NSPs and consumers. This affects the dynamism of these monopolies and can help to restore the requirement that they provide services *in the long term interest of consumers*. At the very least, sound regulatory design should be able to ensure that shareholders, not consumers, carry the burden of inefficient investment and operation.

At the Brisbane Forum, John Pierce also alluded to the fact that investors in network utilities have an international investment market and so Australian network utilities are required to compete in that market to attract investment. We agree with this, certainly in respect of the 25% of the NSP sector in the NEM that is privately owned (obviously the same competition for capital does not exist in the 75% of the industry that remains government-owned). More generally however, we strongly endorse the intent of John Pierce's comments and urge the AEMC to conduct comparative analysis into the regulated rate of return on debt and equity (and actual rates of return achieved) and also into the design of incentives that apply in the economic regulation of electricity networks in other countries, with those that apply in the NEM. The data needed to do this is abundant and easily available.

The AER has proposed changes to the Rules that AP, for the most part, agrees with. In some areas we would like to see the AEMC take the proposals further forward, and in this submission we set out our initial thoughts on this.

We recognise that meaningful reform will require tough decisions which in turn depend upon the AEMC's resolve and determination. The rule changes proposed by the AER, and also by the Energy Users Rule Change Committee, present the AEMC with an opportunity to make step changes to set the industry on a sustainable and fair course. We call on the AEMC to grasp the opportunity to make these badly needed changes.

The rest of this submission proceeds as follows:

- Section 2 examines the evidence of a problem to be solved. The Energy Network Association and Grid Australia has asserted that there is no problem to be solved. This section provides evidence to refute this assertion;
- Section 3 briefly examines the relationship between the conduct of regulation and the role of regulation.
- Section 4 comments on the AER's proposals. This deals with the particular issue of regulatory discretion, which John Pierce specifically requested comments on, at the end of the Brisbane forum;

2 Is there a problem?

In considering whether there is a problem it is useful to summarise the outcomes that NSPs in NEM have delivered:

- Between 2001 and 2011, government-owned distributors have increased their revenue collection per customer from around $600 per customer per year to around $1150 per customer per year. Privately owned distributors will have remained approximately constant at $600 per customer per year;

- Between 2001 and 2011, the regulated asset base (RAB) per connection for privately owner distributors has remained approximately constant at $3000 per connection per year. The RAB per connection for government owned distributors has approximately doubled per connection from $4000 per connection to $8000 per connection over the same period.

- Between 2001 and 2011, the capitalised expenditure per connection has risen from $200 to $300 per connection per year for privately owned distributors, and from $350 to $900 per customer per year for government owned distributors.

Outcomes as remarkable as these demand an explanation.
At the AEMC's Brisbane Forum, representatives from Grid Australia and the Energy Networks Association suggested that there was no problem with regulatory design. Instead it was suggested that if the AEMC wished to deal with rising prices, it should find a way to deal with the increasing uptake of air-conditioners, historic underinvestment (which was blamed on over-zealous regulators in the past) and ageing assets. To the extent that the NSPs offered any recognition of regulatory problems, there was a reluctant acceptance by some that, perhaps, the debt risk premium was too generous. They also suggested that the AER was generally an incompetent regulator that failed to understand network businesses and that it was prone to errors that had to be corrected through appeals to the Australian Competition Tribunal (ACT).

The "rising demand, ageing assets, historic under-spending" rhetoric has been a consistent narrative espoused by network service providers, and at times also by regulatory institutions and governments, to justify expenditure or explain politically unpalatable price control decisions. The idea that exogenous variables have driven expenditure outcomes is appealing. Explanations such these offer comfort that businesses, institutions and regulatory frameworks are working as they should and that the NSPs are responding efficiently to factors which at this point are, unfortunately, causing prices to rise. While this may be an appealing narrative (particularly to the NSPs), the evidence suggests that it is not convincing.

We note that at no point in its rule change proposals has the AER suggested that any of these factors can explain the outcomes that have been observed. We support the AER in this and suggest that there is good evidence to suggest that the expenditure outcomes are not adequately explained by rising demand, ageing assets or historic under-investment. In particular we point to research by Bruce Mountain and Professor Stephen Littlechild in research published through the Electricity Policy Research Group at Cambridge University in 2009 and subsequently in the academic journal, Energy Policy, in 2010[1]. This initial research was subsequently extended in research commissioned by the Energy Users Association of Australia and published in May 2011.[2] It is useful to summarise the findings of this research in respect of the claims made by NSPs that expenditure outcomes are attributable to rising demand, ageing assets and historic underinvestment:

- **Rising demand:** the report found that electrical demand has grown more strongly in Victoria than in Queensland and far more strongly than in New South Wales[i]. Yet growth-related expenditure allowed by the AER has been four times higher per connection for government owned distributors in New South Wales and Queensland than for privately owned distributors in Victoria and South Australia. This suggests the main issue seems to be an inefficient response to demand growth by government owned distributors, sanctioned by the regulator.

- **Ageing assets:** the report found that government owned distributors in New South Wales and Queensland have an effective average remaining asset life of 31 years. The private distributors claim 22 years effective average remaining asset life. If the replacement of ageing assets is an explanatory factor then it would be expected that privately owned distributors would be spending more to replace assets that are nearer the end of their lives. Yet the government owned distributors have been given regulatory allowances that result in them charging

[1] Mountain, B.R., Littlechild, S. C., May 2010. *Comparing electricity distribution network revenues and costs in New South Wales, Great Britain and Victoria.* Energy Policy 38 (2010) 5770–5782

[2] Mountain, B.R., May 2011. *Australia's rising electricity prices and declining productivity: the contribution of its electricity distributors.* Energy Users Association of Australia, Melbourne.

[i] The *rate* of demand growth has been comparable in Victoria and Queensland.

energy users four times more per connection to replace ageing assets, than the privately owned distributors charge. This suggests the main issue is an inefficient response to asset ageing by government owned distributors and this inefficient response has been approved by the AER.

- **Historic underinvestment:** the report found that the New South Wales Government and the Energy Supply Association of Australia commissioned studies in the 1990s that concluded that NSW distributors were inefficient and their capital productivity was poor. The synthesis report describing these studies was authored by John Pierce et al. Its logical conclusion is historic over-investment, *not under-investment*, by NSW distributors. Since the time of those studies, expenditure by New South Wales distributors has consistently risen, not fallen, in absolute terms and per customer served. In Queensland in 2004 the Independent Panel (otherwise known as the Somerville Review) concluded that under-investment explained poor service outcomes by Queensland distributors. But the service outcomes for Queensland's biggest distributor that serves three-quarters of Queensland's users were above the Australian average. For the other distributor, it is not clear that the problem was historic underinvestment rather than co-ordination and planning deficiencies following Government approved, but apparently poorly executed, mergers in the previous five years.

Instead of this troika of exogenous variables, the Mountain report pointed to the role of ownership, the conduct of regulation, asset valuation, and arrangements for appeal along with regulatory design as factors that might explain the observed outcomes.

Other significant institutions and individuals have come to similar conclusions. For example the Parry-Duffy report commissioned by the Government of New South Wales in December 2010, pointed to the scope for greater efficiency in the NSW NSPs to fund price reductions and in conclusion noted:

"…*dual and conflicting roles that government has as owner of the network businesses and as policy maker*".

The Parry-Duffy report then suggested that the resolution of this:

"*would enable a more coherent balancing of public policy objectives against the commercial objectives of the (network) businesses*" … and would also enable … "*a more appropriate consideration of the drivers for network expansion and upgrades that drive large increases in capital expenditure and operating costs*".

To speak plainly, Parry-Duffy's assessment is that Government ownership of networks in NSW had affected expenditure decisions to Government's benefit but to energy users' detriment.

The Garnaut Update Report in 2011 concluded that flaws in the regulatory design, arrangements for the appeal of regulatory decisions and continued government ownership had led to excessive allowed returns which had in turn led to "*overinvestment in networks and unnecessarily high prices for consumers*".[3]

In June 2011, Professor Tom Parry, previously the Chairman of the Independent Pricing and Regulatory Tribunal, said that:

".. the fundamental role of incentives appears to be missing from regulation today. The regulator doesn't appear to accept that a business will drive all of its costs, including efficient financing costs, so that customers can share in those benefits. And some of the businesses, notably the government-owned businesses, are not demonstrating the same governance drivers that gives the regulator confidence that the incentive model will work. For incentive regulation to work, the owners and management of the regulated network need to actively seek out every opportunity to drive efficiency in all the costs of the businesses. Whether all of the government-owned businesses in NSW and Queensland (and Western Australia) have the same drivers that we saw in the 1990s and early 2000s is starting to be questioned. And if governance is not transparently aligned to efficiency incentives, then the Australian regulatory model is very close to broken. How to fix it? That is the billion-dollar question. Hopefully, policy-makers at state and national levels of government will re-engage with this critical area of micro-economic reform. They need to; there is substantial economic welfare at stake."

In July 2011, the Independent Pricing and Regulatory Tribunal (IPART) expressed concern that

[3] Garnaut, R. 2011. "*Garnaut Climate Change Review – Update 2011, Update Paper 8: Transforming the electricity sector*". Pages 38 to 47.

"…*network costs are higher than necessary, because of certain aspects of the current regulatory framework, including the economic regulation of networks under the National Electricity Rules (NER) and the standards for network reliability and security*."[4]

IPART then suggested that

"*economic regulation aspects of the NER, including the placement of an unusually high burden of proof on the regulator, unbalanced rules for appeal and prescriptive approaches to determining the network businesses' returns, may bias decisions in favour of higher prices and inefficient outcomes*."[5]

In October 2011, the Tamberlin Report concluded that

"*Overall, the evidence before the Inquiry tends to support the view that privatisation of the network businesses would lead to efficiency gains over time. This would result in more effective capital investment, which should result in a reduction in the charges permitted to be levied for the business in the next regulatory period.*"[6]

Finally, we understand that IPART completed a report on the productivity of the New South Wales distributors in 2010, for the Treasurer of New South Wales. We understand that this report examines the steep decline in the productivity of the NSW distributors, and that it may be publicly available soon.

There can be no doubt about the existence of a problem that merits thorough examination by the AEMC, and whose resolution demands far reaching changes. As we noted earlier, it would be inappropriate to apportion all of the blame for the outcomes on regulatory design, nevertheless we submit that this is part of the explanation. The next sections explore this in greater detail.

[4] IPART, June 2011. "*Changes in regulated electricity retail prices from 1 July 2011*", Draft Report. Page 82.
[5] Ibid.
[6] Tamberlin, October, 2011. "*Final Report of the Special Commission of Inquiry into the Electricity Transactions*". Page XX.

3 Is the problem the conduct of regulation or the design of regulation?

Grid Australia and the Energy Networks Association have claimed that the problem is the conduct of regulation, rather than regulatory design. Their claim is that the AER does not understand their businesses and that it is prone to error (which is why they say they have so frequently sought merits review of the AER's decisions by the Australian Competition Tribunal).

By inference these networks associations and their members assert that if the problem with the conduct of regulation was rectified, regulatory allowances would be even more generous than they have been. This is a somewhat different interpretation to the problem of the conduct of regulation alluded to by Mountain and Littlechild (2010) who suggested that the AER might be able to go further (i.e. set tougher price controls) even within the existing regulatory framework. They pointed specifically to the determination of the allowed rate of return and to the use of benchmarking.

We suggest that the claims by Grid Australia and the Energy Networks Association are easily dismissed. It is all too easy to assert that the regulator has failed to understand their business and if it had not done so, even more generous regulatory allowances would have been provided. This is a hollow assertion.

The substantive issue is that NSPs have failed to respond to the evidence that the factors that they assert have driven expenditure (demand growth, ageing assets, historic underspending) are in fact poor explanations: as discussed in the previous section some NSPs are evidently able to respond to these factors very much more efficiently than others. It is for the laggards (typically the government-owned NSPs) to refute this evidence before claims that the regulator has failed to understand their businesses can be taken seriously.

Returning to the substantive issue of the relative contribution of regulatory design and the conduct of regulation to the observed outcomes, our assessment is that in many cases it is difficult to establish the relative importance of the design of regulation and the conduct of regulation in explaining the observed outcomes.

One view is that the AER may be less constrained by the existing Rules than it suggests it is. An alternative view is that the AER is bound by a narrow reading of the

Rules in order to avoid lengthy appeals against its decisions, not least in view of the scarce resources that such appeals can consume. Ultimately this does not need to be resolved in assessing the AER's proposals. The AER has said unequivocally that it feels excessively constrained by the Rules. It made this view known during the consultation on the Chapter 6A Rules in 2006, and now five years later it is making the same views known again. As the next section discusses in greater detail, the AER has proposed some specific changes to the Rules to strengthen its ability to assess NSP expenditure proposals. Australian Paper generally supports these proposals.

4 Comment on the AER's proposals

This section sets out Australian Paper's comment on the AER's proposals. It comments firstly on the issue of discretion versus prescription, which John Pierce has specifically sought comment on, as discussed at the Brisbane Forum. It then comments on the AER's proposals on the capex and opex framework, capex incentives and regulatory processes.

4.1 Discretion versus prescription

The AER's proposal suggests that prescription (what it calls "the detailed codification of the methodology of economic regulation") has hindered its ability to "*appropriately"* regulate NSPs. Specifically it has claimed that such detailed codification:

"..*has restricted the AER's ability to effectively balance the interests of both consumers and regulated NSPs when making regulatory determinations and hindered the AER's ability to respond flexibly to changing circumstances*".

The AER suggests that this has resulted in regulated prices higher than the level associated with efficient investment and operation by NSPs. [7] The AER is suggesting that there is a dichotomy between prescription (which it suggests is in NSPs interests) and discretion (which it suggests is in consumers' interests).

We partly agree with this description of the problem. AP's view is that the Rules need to ensure that the AER is properly empowered to undertake its duties. Specifically, the AER must be able to make decisions "in-the-round" reflecting information and argument presented to it by the NSPs, but also its own critical assessment of such information and argument. Often such critical assessment will rely on the exercise of judgement reflecting consideration of NSPs' incentives (both in the construction of their regulatory proposals and in the subsequent execution of their activities).

[7] AER proposal, page 12.

Typically such judgements are not conducive to arithmetic demonstration or variance analysis against an NSP's proposal. The design of the regulatory regime must ensure that the AER is empowered to make such judgements, without needing to present calculations to the NSP's satisfaction, or to explain these changes as variances against the NSP's proposals.

In this regard, we suggest that there are two specific clauses in the Rules that discriminate against the AER exercising its judgement, as it reasonably should be allowed to. In particular:

- **Presumption in favour of the NSPs:** Chapter 6 (6.12.3(f)(1) and 6A (6A.13.2(a)(2) limits the AER's discretion to vary NSPs proposals by requiring the AER to adjust NSP's claims "on the basis of" the NSPs proposals.
- **Onus of proof:** (clause 6.12.2(ii)) sets specific requirements that the AER needs to satisfy in demonstrating to DNSPs that they are wrong. By contrast, the widely accepted process in public administration and economic regulation is the other way around: the regulator specifies the requirements that the regulated businesses need to meet to establish their claims to the regulator satisfaction.

The AER is accountable for the conduct of regulation and if it feels unduly constrained in its ability to exercise discretion then relaxing such constraints may help to restore the AER's proper accountability, and the integrity of the system of economic regulation.

However, while the RCC supports changes to the Rules in these areas, in a more general sense, we suggest that prescription is not *necessarily* in NSPs interests, and neither is discretion *necessarily* in consumers' interests. For example, giving more discretion to a regulator that was inclined towards NSPs might be expected to result in decisions more favourable to NSPs, than would be the case if there were prescriptive rules that restricted the regulator's ability to do this.

As such, we suggest that describing the problem as a dichotomy between prescription and discretion is not useful. The problem is better described as poorly-specified prescription. Well-specified prescription might be expected to satisfy certain characteristics, such as it:

1. reduces regulatory risk to the benefit of NSPs and energy users;
2. lowers costs in the administration of regulation;

3. promotes regulatory accountability; and
4. recognises the incentives established through the system of regulation and the NSPs response to those incentives.

In the rest of this section, we apply this thinking in our comments on the AER's proposal to change the rules in respect of the opex/capex framework, incentive design, the treatment of the cost of capital and changes to regulatory procedures.

4.2 The AER's proposals for the determination of opex and capex allowances

The AER has proposed the following changes to arrangements for the determination of opex and capex allowances:

1. Remove the requirement that the AER has to accept an NSP's proposed opex or capex if it reasonably reflects the required expenditure;
2. Remove the requirement on the AER to determine an opex/capex allowance "based on" the distributor's proposal (applies to distributors only);
3. Deletion of most "expenditure criteria" including the criterion requiring the AER to have regard to the circumstances of the transmission or distribution NSP;
4. Re-ordering various expenditure factors and adding a "catch-all" factor so that the AER can consider any other factor that it wishes to.

The AER has suggested that the rules it refers to, encourage NSPs to propose higher levels of expenditure during the regulatory period than is likely. The AER also suggests that the rules that it refers to force the AER to develop a line-by-line assessment of an NSP's opex and capex proposal.

Fixing prices or revenues for a period of time – as is the case with the price/revenue cap regulatory model specified in the Rules - creates an incentive for NSPs to propose higher expenditure levels than they think likely. This is not an outcome of the specific rules that the AER has referred to, and neither is it likely that the AER's proposal to change these specific rules will change this incentive. In addition, it is not clear that the existing arrangements necessarily force the AER into a line-by-line assessment of NSP expenditure proposals, as the AER has suggested. However, AP supports the AER's proposed changes in this area for the following reasons:

1. Removing the requirement on the AER to accept an NSP's proposal if it reasonably reflects the required expenditure is a sensible simplification of the Rules. If a proposal was reasonable, the AER can be expected to accept it, the AER does not need to be instructed to do so;
2. Removing the requirement to determine opex/capex allowances "based on" a distributor's proposal is a sensible change. Restricting the AER to make changes based on distributors' proposals can be expected to have unreasonably restricted the AER's discretion, to NSPs' benefit and at consumers expense;
3. Removing the expenditure criteria from the Rules is again a useful simplification; it is particularly valuable to delete the requirement that the AER have regard to the circumstances of the NSP. Such a requirement is at odds with the philosophy underlying price cap regulation (i.e. the purpose of the regulation is to mimic outcomes that would be delivered in competitive markets and in competitive markets consumers don't pay more to compensate for the competitive weaknesses or inefficiencies of the competing producers).
4. Adding a "catch-all" expenditure factor so that the AER can consider any other expenditure factor that it wishes to, is a sensible addition to the AER's discretion.

In summary, while it might be argued that there is more that the AER could do even within the current Rules; the AER's proposals are at the least a sensible simplification of the existing Rules. That the AER considers that these changes promote regulatory accountability is an added attraction. On this basis, AP supports their adoption.

4.3 The AER's proposals on incentive design

The AER has proposed several changes to the design of incentives to make these incentives more powerful – particularly in the circumstances that NSP spend more than their regulatory allowances (as has typically been the case for government-owned NSPs). The AER's main proposals in this area are as follows:

1. **Strengthening the incentive not to overspend the allowance:** Only capex up to the forecast would be automatically added to the regulatory asset base. Forty per cent of capex in excess of the allowance would be funded by shareholders and the remaining 60 per cent would be borne by customers;
2. **Discretion to decide depreciation calculation:** The calculation of the closing regulatory asset base would be based on depreciation of the actual expenditure incurred or the allowed expenditure, with the choice at the AER's discretion.

3. **Re-openers:** DNSPs can apply to re-open regulatory decisions during the regulatory control subject to a $10m threshold (only applications to increase expenditure by more than $10m will be considered and the AER proposes that this trigger level will be amenable to change by the AER);
4. **Contingent projects:** DNSPs can propose “contingent projects” during the regulatory control determination. This would allow for a more-or-less automatic adjustment of the regulatory allowances if investment in those contingent projects proceeds during the regulatory control period;
5. **Pass-thoughts:** NSPs can apply to pass-through certain costs subject to the impact of those costs being greater than 1% of regulated revenues.
6. **Ex-post adjustment of the RAB:** in the calculation of the regulatory asset base at the end of the regulatory control period, the AER reserves the right to adjust the RAB to exclude the impact of changes in capitalisation policy or related-party margins.

The design of regulatory incentives is a complex subject and merits detailed consideration. The comments in this section should be considered preliminary and subject to further consideration.

There is little doubt that the regulatory incentives established by the AEMC are too weak. Detailed monte-carlo simulation of these incentives by Mountain-Nuttall Consulting in 2005 which was included in the ACCC’s submission to the AEMC in the Chapter 6 review, concluded that it was highly likely that NSPs would over-spend their allowances because the incentives to reduce capital expenditure below the regulatory allowances were too weak. This is indeed exactly what has occurred with the government-owned TNSPs to which this regime applied, and also the government-owned DNSPs under similar regimes applied by QCA and IPART in their previous regulatory control periods. As such, the case for strengthening the penalty for over-spends is sound and AP fully supports the AER in this.

The AER’s proposed 40/60 split is arbitrary – as indeed would be any split. An important factor in choosing this split would be whether it is sufficiently large as to provide an adequate discipline on NSP expenditure, particularly by government-owned NSPs. Our initial view is that the proposed 40/60 split should provide an adequate discipline on NSPs to spend within their regulatory allowances.

The remaining elements of the AER’s proposals on the design of incentives are less attractive. While the AER has strengthened the penalties faced by NSPs for overspending regulatory allowances, it has included provisions for re-openers, contingent projects to be applied to DNSPs (they already apply to TNSPs) in addition to the existing pass-through arrangements.

These additional provisions weaken the capital expenditure disciplines (why bother to constrain expenditure if you can just apply to the AER for a contingent project, pass-through or re-opener). Furthermore these mechanisms create moral hazard, encourage cost shifting and reward rent-seeking. The philosophy underlying price cap regulation is that NSPs will be set a reasonable expenditure allowance (which users would be required to pay) on the clear understanding that the future is uncertain and hence the efficient level of expenditure is uncertain. It is for the NSPs to discover the efficient level of expenditure in response to incentives that allow them to increase their profits if they reduce expenditure below regulatory allowances. The price cap regulatory approach recognises that much of an NSP's expenditure program is fungible and that what is lost on the swings will be gained on the roundabouts.

The AER's proposals undermine the philosophy of price cap regulation by providing many other ways in which NSPs may recover expenditure from consumers, other than through the main price control. Presumably the AER was minded to bolster these various forms of cost pass-through on the basis that if it did not do this, NSPs might not be able to meet their reliability targets if future events turned out to be less benign than expected. But the arrangements that the AER has proposed are at the expense of weaker cost control and hence higher prices to all energy users.

There are other ways that the AER might ameliorate its concern about reliability of service provision by, for example, strengthening service standard incentives so that NSPs suffer material financial losses if they fail to meet reliability performance standards.

If the AEMC is minded to extend the contingent project and re-openers to DNSPs as the AER has proposed, we suggest that the AEMC might consider protections against cost-shifting, rent seeking and moral hazard. This might be achieved through:

- Some form of "excess" so that NSPs are required to absorb the first $x millions of any claim before costs associated with contingent expenditure; pass-throughs or re-openers are reflected in regulated charges;
- Restricting the ability of an NSP to apply for a re-opener or contingent project only if the total capex and opex during the regulatory period has exceeded the allowed expenditure for the period.

- Requiring the NSPs to demonstrate that substitution of projects (as any other business would be obliged to do) had been considered and a detailed report being provided showing why this approach was not a viable option.

Ultimately the incorporation of so many additional intra-regulatory period adjustment mechanisms undermines the fundamental design intent of price-cap regulatory controls - which is to fix prices/revenues for a defined period of time and through this establish incentives for TNSPs to efficiently manage costs, with the benefit of such cost reductions being shared with consumers through price reductions in subsequent regulatory periods.

Incentive design matters and AP would prefer to see a carefully developed analysis of alternative regulatory designs. Arguably the available evidence suggests that that price cap regulatory forms have not been successful in the economic regulation of government-owned NSPs – and hence alternative approaches merit consideration. The AER's proposals have not considered or evaluated alternative designs and so we would like to encourage the AEMC to undertake such consideration as part of its review.

Finally, the AER's proposal that it should have discretion to decide the basis upon which it calculates depreciation (proposed or actual expenditure) might be considered further. An important consideration in incentive design is ensuring that investors and managers understand the incentives that they operate under. As such, we suggest it would be better to settle on one or the other basis for the calculation of regulatory depreciation, rather than leave it to the AER to decide in each regulatory decision. Our preference would be for the use of actual expenditure in the calculation of the closing regulatory asset base.

4.4 The AER's proposals on the cost of capital

The AER has proposed:

- the withdrawal of the provisions in the Rules specifying the calculation of the return on debt, and in its place the AER should be allowed to determine the return on debt as part of its periodic WACC reviews;
- the withdraw of the provisions in the Rules for the calculation of the risk free rate; and

- the withdrawal of the provisions in Chapter 6 requiring the AER to vary the Weighted Average Cost of Capital (WACC) parameters from the values determined in its periodic WACC reviews if there is persuasive evidence to do this.

The AER's proposal on the specification of the return on debt can be contrasted with the Energy Users Network Rule Change Committee's (RCC's) proposal that the regulatory determination of the return on debt should be specified in the Rules, based on the RCC's recommended formulation. The RCC's rule change proposal sets out in detail why the RCC considers that the Return on Debt should be specified in the Rules rather than being left to be determined in periodic reviews by the AER. Rather than reiterate those arguments here, AP refers the reader to the RCC's proposal document for a detailed presentation of those arguments.

The remaining questions (from Australian Paper's perspective) is whether to support the AER's proposal:

- to change Chapter 6 (to withdraw the requirement to change parameters if there is persuasive evidence to do so);
- that the specification of the risk free rate be taken out of the Rules (both Chapter 6 and Chapter 6A).

AP's preliminary view is to support the AER's proposals on the first of these, but not the second. On the first, the "persuasive evidence" clause has been used by NSPs to appeal AER decisions. These appeals on the averaging period for the risk free rate, and Gamma, have had a very significant impact on electricity prices – an impact that would have been even higher if the Queensland Government had not chosen to reject the outcome of the ACT's Gamma decision based on the ACT appeal that its own distributors had raised. There is reason to be very concerned about ACT decisions on WACC – not least in view of their impact on electricity prices – which the ACT did not even consider in its decision on either the value of Gamma or the averaging period for the risk free rate. For these reasons AP agrees with the AER's proposals to eliminate the "persuasive evidence" clause from Chapter 6, and with it the ACT's review of some of the AER's WACC decisions.

On the AER's proposal that the specification of the risk free rate be taken out of the Rules, AP's preliminary view is not to support this. The rate is used in the calculation of the return on equity. While AP does not support the existing specification of the risk free rate and its calculation, the fact that it is written into the Rules allows energy users to propose to the AEMC that it be changed. This would not be possible if the AER determined the specification of the risk free rate.

4.5 The AER's proposals on procedural amendments and confidential information

The AER has proposed:

- NSPs be restricted from making submissions on their own revenue/price control proposals;
- the AER should have discretion to apply less weight to information that NSPs claim confidentiality on (as it can with respect to information provided by other stakeholders).

The proposed changes mean that NSP's would no longer be allowed to make submissions on their own initial proposal, the AER's draft decision, or their own revised proposal. NSPs can respond to the draft decision through their revised proposal (and not through submissions or through a combination of their revised proposal and submissions). The proposed rules would also require the AER to not consider new information in a NSP's revised proposal which goes beyond responding to the draft decision.

AP unequivocally supports the AER's proposals on procedural amendments and limiting the weight to be placed on confidential information. The AER provided clear evidence of strategic behaviour by NSPs – particularly DNSPs - in their provision of information to the AER. Such strategic behaviour contravenes the standards expected of a transparent and accountable regulatory process and the AER's proposal to deal with this seems to be a reasonable and proportionate response. Similarly AP supports the AER placing less weight on confidential information provided to it by NSPs (as it does with respect to confidential information provided by other stakeholders).