

Response to the AEMC’s Directions Paper: National Electricity Amendment
(Economic Regulation of Network Service Providers) Rule 2012
National Gas Amendment
(Price and Revenue Regulation of Gas Services) Rule 2012

The Financial Investor Group

16 April 2012



Contents

| | |
|--|-----------|
| 1. Executive Summary | 1 |
| 1.1 Rate of return framework..... | 1 |
| 1.2 Capex incentives and <i>ex-post</i> review | 1 |
| 2. Background | 3 |
| 2.1 What the AEMC is seeking | 3 |
| 2.2 Submission overview | 3 |
| 2.3 Report outline | 3 |
| 3. The rate of return framework..... | 4 |
| 3.1 Summary..... | 4 |
| 3.2 The AEMC's initial position | 4 |
| 3.3 Our comments on the AEMC's initial position..... | 7 |
| 3.4 Responses to the AEMC's specific questions..... | 12 |
| 4. Capex incentives and <i>ex-post</i> review | 16 |
| 4.1 The AEMC's initial position | 16 |
| 4.2 Our comments on the AEMC's initial position..... | 17 |
| 4.3 Responses to the AEMC's specific questions..... | 18 |

Inherent Limitations: This report has been prepared solely for the purpose outlined in Section 2 of this report. The report indicates the sources of the information used. Members of the FIG have not sought to independently verify those sources unless otherwise noted within the report.

Third Party Reliance: Other than our responsibility to the Australian Energy Market Commission, no FIG member undertakes responsibility arising in any way from reliance placed by a third party on this report. Any reliance placed is that party's sole responsibility.

1. Executive Summary

The Financial Investor Group (“FIG”) welcomes the opportunity to provide a submission responding to the AEMC’s Directions Paper on the rule change proposals (“the proposals”) regarding the economic regulation of electricity and gas networks.

This submission focuses on the key issues and evidence that the FIG believes the AEMC should take into account in further considering its initial positions in respect of the various rule change proposals. It focuses on the issues of particular concern to the FIG, which include:

- ▶ the rate of return framework; and
- ▶ capital expenditure (“capex”) incentive issues and the potential for *ex post* review of capex in particular.

This submission should be read in conjunction with the FIG’s response to the AEMC’s consultation papers, which provides further context for the views expressed and the evidence relied upon.¹

1.1 Rate of return framework

The FIG broadly agrees with the initial position on rate of return which the AEMC has advanced in the Directions Paper and is supportive of many of the specific proposals put forward.

The FIG supports the use of a single rate of return framework across electricity transmission, electricity distribution and gas. A properly designed framework should allow recognition to be given to the real differences between regulated businesses operating in each of these sectors.

To promote confidence in regulator decision-making on rates of return (i.e. in its certainty and predictability), the FIG supports a framework in which:

- ▶ rate of return outcomes - rather than the methods of rate of return determination, and the parameter values used with those methods - are subject to a market test;
- ▶ adequate guidance is provided for rate of return determination to provide a suitable degree of regulatory certainty and predictability; and
- ▶ merits review remains an essential element of the framework.

Ultimately, from the FIG’s perspective, the application of any rate of return framework, regardless of whether it is based on any existing frameworks, must ensure that the rate of return delivered reflects a service provider’s efficient financing costs at the relevant time the decision is made. If it does not do this, it cannot contribute to meeting the NEO or the NGO.

1.2 Capex incentives and *ex-post* review

The FIG is in broad agreement with much of the AEMC’s initial position in respect of capex incentives, as noted below. This section only relates to electricity service providers.

¹ FIG, AEMC Consultation Papers: rule change proposals relating to the economic regulation of electricity and gas networks, 8 December 2011

The FIG is, however, opposed to any *ex post* review of capex.

This is primarily because there is no evidence of a capex 'overspend' problem; at least outside of governance issues. The FIG's submission to the AEMC's consultation papers provided that evidence.

The evidence suggests that the introduction of the *ex post* review of capex can only be for the purpose of addressing overspending that occurs for other reasons (i.e. governance issues). However, as a matter of broad principle, the AEMC states that "*First, regulation cannot compensate for weaknesses in corporate governance arrangements.*"²

The FIG supports strengthening the incentive to optimise capex through the extension of the efficiency benefit sharing scheme ("EBSS") to capex, and its members would accept the associated risks. Combined with service (e.g. reliability) standards and incentives, this provides the most appropriate and practical mix of incentives to deliver efficient levels of capex. The EBSS should be symmetrical as it is for opex.

Such an approach would be consistent with incentive-based regulation, which the FIG believes is ultimately the best way to protect the long term interests of electricity consumers.

² AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Directions Paper, AEMC, 2 March 2012, Sydney. Page ii

2. Background

2.1 What the AEMC is seeking

The Directions Paper outlines the AEMC's initial positions on the proposed rule changes and the next steps it proposes to undertake to test those initial positions.³ It poses specific questions that it is seeking responses to assist it in this process.

2.2 Submission overview

This submission seeks to address the questions raised by the AEMC and provide supporting evidence for the views expressed wherever possible. In respect of the issues on which the FIG wishes to comment, this submission:

- ▶ summarises the FIG's understanding of the AEMC's initial positions;
- ▶ provides some broad comments relevant those initial positions; and
- ▶ answers the specific questions posed by the AEMC.

2.3 Report outline

This report provides the output of our analysis. In particular:

- ▶ Section 3 - addresses the rate of return framework; and
- ▶ Section 4 - addresses capex incentives and *ex post* review in particular.

³ AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Directions Paper, AEMC, 2 March 2012, Sydney.

3. The rate of return framework

3.1 Summary

The AEMC argues, in its Directions Paper, that there is a case to amend the rate of return frameworks in NER and NGR in order to address issues which have been raised by the AER and raised in submissions made by stakeholders. In particular, the AEMC sees a need for a framework or frameworks which better facilitate response to change and provide sufficient high level guidance for decision-making, acknowledging that there may be trade-offs required in achieving these competing objectives.

The AEMC has a preference for a single framework to be used across electricity transmission, electricity distribution and gas. That framework should continue to be based on estimation of a WACC for a benchmark efficient firm, although that firm could be different for the different types of service providers (i.e. electricity transmission and distribution and gas service providers).

The FIG broadly agrees with the initial position which the AEMC has advanced in the Directions Paper, and is supportive of many of the specific proposals put forward, as is noted in the relevant sections of this submission below.

However, the FIG is concerned that the AEMC's initial position may be quickly reduced to technical debate over models and parameters, reintroducing into rate of return determination the inflexibility in response to change that is particularly evident in the current electricity frameworks and which, from there, affected the gas framework.

The FIG supports the use of a properly designed single rate of return framework to be used across different types of service providers. A properly designed framework would allow recognition to be given to the real differences between regulated businesses operating in electricity transmission, electricity distribution and gas.

To promote confidence in regulator decision-making on rates of return (i.e. in its certainty and predictability), the FIG supports a single framework in which:

- ▶ rate of return outcomes - rather than the methods of rate of return determination, and the parameter values used with those methods - must be subject to a market test;
- ▶ adequate guidance is provided for rate of return determination to provide a suitable degree of regulatory certainty and predictability; and
- ▶ merits review remains an essential element of the framework.

3.2 The AEMC's initial position

Three different rate of return frameworks are set out NER and NGR. These are:

- ▶ the framework of Chapter 6A of the NER for electricity transmission;
- ▶ the framework of Chapter 6 of the NER for electricity distribution; and
- ▶ the framework of Rule 87 of the NGR which applies to gas pipeline service providers.

The three frameworks differ, as the AEMC notes, in terms of their levels of prescription and flexibility.

Effectiveness of the Chapter 6A framework for electricity transmission

The AEMC is concerned that the rate of return framework in Chapter 6A of the NER appears to be no longer effective for the following reasons:

- ▶ the stability and certainty provided by the framework are achieved at the expense of a rate of return for electricity transmission network service providers which, over time, becomes increasingly less relevant to their circumstances;
- ▶ parameter values cannot be adjusted for errors which might be made at the time of a WACC review because the outcomes of the review are not subject to merits review; and
- ▶ parameter values cannot be adjusted to accord with changes in the availability of market data.

In consequence, WACC estimates may not be commensurate with market conditions. As a result:

- ▶ service providers may be unable to finance needed investment; and
- ▶ customers may pay more for transmission network services than should be the case.

Each of these outcomes is inconsistent with the NEO. Each is detrimental to the promotion of efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity.

A good rate of return framework should, in the AEMC's view, be flexible enough to allow consideration of new information or data sources, and should allow for merits review of WACC parameters to correct errors made by the regulator.

Effectiveness of the Chapter 6 framework for electricity distribution

The rate of return framework of Chapter 6 of the NER provides mechanisms which allow the values of WACC parameters to change over time in ways which are precluded under the framework in Chapter 6A. However, the AEMC considers that:

- ▶ the AER may, in consequence, have to devote additional resources to assessing rate of return material put before it in the required revenue proposals of electricity distribution network service providers;
- ▶ electricity distribution network service providers may attempt to "cherry-pick" certain WACC parameters for merits review; and
- ▶ the persuasive evidence test of Chapter 6 may be difficult to apply in practice.

That service providers may attempt to cherry-pick certain WACC parameters for merits review has been the reason given by the AER and others for proposals to limit access to merits review. The AEMC is, however, concerned about the effects of those proposals. The rate of return contributes a significant portion of service provider regulated revenue, and the AEMC is of the view that there should be sufficient regulatory accountability to ensure that errors made by the regulator are corrected.

The FIG addressed this issue in detail in its submission to the AEMC's consultation papers, and subsequently in its submission to the Expert Panel of the Standing Council on Energy and Resources established to review the performance of the merits review regime.⁴

Effectiveness of the gas framework

Positive features of the NGR rate of return framework identified by the AEMC include:

- ▶ flexibility, requiring that the rate of return be determined at the time of each access arrangement revisions approval process, and thereby allowing the AER and the ERA to have regard to current market circumstances; and
- ▶ flexibility, allowing the AER and the ERA to take into account and consider all of the latest available information on estimation techniques, data and methodologies at the times of their decisions.

Against this flexibility, the AEMC found that the NGR framework provided for very open ended debate on what approach would provide the best estimate of rate of return.

The AEMC noted that the flexibility which the gas framework affords the AER and the ERA, while not resulting in any change of approach to date, has at least allowed alternatives to be considered in light of evolving theoretical and empirical evidence. In these circumstances, prescribing a particular model in the rules may unnecessarily restrict the regulator from considering evidence or information that would support using alternatives.

The AEMC concluded that the framework of the NGR had merit: a more flexible approach, which allowed the regulator to consider more information, may be more appropriate.

Case for a common rate of return framework

The NER and the NGR should, in the AEMC's view, allow the regulator to determine a benchmark efficient firm for the purposes of estimating the rate of return. That benchmark efficient firm would be based on the specific characteristics of the electricity network service provider or gas service provider that affect the degree of non-diversifiable risk of the network business.

This would imply that the rate of return framework would need to allow a regulator to choose a different benchmark efficient firm for different types of electricity transmission, electricity distribution and gas pipeline service providers.

The AEMC sees some merit in the idea of a common WACC framework within which the regulator would determine parameter values from the perspective of a benchmark efficient electricity network or gas pipeline service provider appropriate to the circumstances.

AEMC initial position

The key elements of the AEMC's initial position on rate of return frameworks for the NER and the NGR are:

- ▶ preference for a single framework to be used across electricity transmission, electricity distribution and gas;

⁴ FIG, Review of the Limited Merits Review Regime in the National Electricity Law and National Gas Law, 13 April 2012.

- ▶ a framework which continues to be based on estimation of a WACC for a benchmark efficient firm, although that firm could be different for electricity transmission, electricity distribution and gas service providers; and
- ▶ provision of sufficient regulatory accountability to ensure that any errors potentially made by the regulator are corrected.

3.3 Our comments on the AEMC's initial position

Preference for a single framework

The FIG supports the use of a properly designed single rate of return framework to be used across electricity transmission, electricity distribution and gas service providers.

As the AEMC has argued, a common rate of return framework would not imply that the same parameter values should always be adopted for each and every electricity network and gas pipeline service provider. The regulator would be allowed to assess the values of the parameter estimates from the perspective of what it considered to be a benchmark efficient service provider appropriate to the circumstances.

Design of the single rate of return framework would be guided by the NEO and the NGO, and by the revenue and pricing principles which are common to both the NEL and the NGL.

Guidance provided by the NEO and the NGO

In advancing its initial position, the AEMC has - in the FIG's view, correctly - seen design of the rate of return framework as being governed by the NEO and the NGO.

A rate of return delivered by application of the framework must ensure that a service provider is able to earn a return on capital that should allow the recovery of at least its efficiently incurred financing costs. Allowing the recovery of these costs should ensure that finance can be attracted into the service provider's business at minimum cost to consumers of the services provided using the assets which have been financed (prudent investment). The NEO and the NGO are more likely to be met if the NER and the NGR, respectively, allow for a rate of return which reflects a service provider's efficient financing costs.

The focus of the rate of return framework must, in these circumstances, be the outcome from rate of return determination, and not the technical issues which arise in consideration of methods of WACC calculation and the estimation of parameter values used with those methods.

A framework which ensures that the rate of return delivered reflects a service provider's efficient financing costs would apply a market test to the outcome. That market test would likely have a form similar to the market test which is currently in the gas framework. The test would require a rate of return which was commensurate with prevailing conditions in the market for funds and the risks involved in providing the relevant services.

Primacy of a market test

Much of the debate over rate of return has focused on methods and on estimation of the parameter values to be used with those methods.

The methods of WACC calculation require the use of financial models like the Capital Asset Pricing Model (CAPM). Use of any specific method, and of any specific financial model, involves simplification and approximation. The CAPM, for example, is a simplified description of complex financial market interactions and cannot, itself, provide a complete view of the way in which the rate or return equity is determined. The simplification and approximation

which necessarily accompany the use of particular methods and financial models, and the errors which occur in the estimation of the parameter values to be used with those methods and models, mean that their use may not deliver a rate of return which reflects a service provider's efficient financing costs. Their use in any particular instance of rate of return determination may not contribute to achievement of either the NEO or the NGO.

Once the NEO and the NGO are seen as governing design of the rate of return framework, methods of WACC calculation, and the estimation of parameter values become subordinate to the outcome to be achieved. They become subordinate to a market test of the rate of return outcome.

Essentially, market testing would require that the regulator consider not only a range of market evidence and commercial considerations relevant to the determination of the rate of return in each particular case, but also the way in which market experts deal with problems relating to data and limitations in the underlying approaches and financial models. This was highlighted in the FIG's submission to the AEMC's consultation papers.

Although the FIG strongly supports a rate of return framework which gives primacy to a market test of the rate of return outcome, it recognises that rate of return determination is a complex and multifaceted process. In any specific instance, regulatory decision-making may not proceed efficiently and without unnecessary dispute if some guidance is not provided on the application of a market test.

The current gas framework provides a potential model, although that model is not ideal. Rule 87(1) of the NGR sets out a market test. Rule 87(2) provides guidance on establishing a candidate rate of return which might satisfy that market test.

The FIG notes that the model provided by Rule 87 of the NGR suffers from ambiguity in the drafting. Resolution of the ambiguity is among matters which Western Australian gas pipeline service providers, ATCO Gas Australia and DBP, have brought to the Australian Competition Tribunal ("ACT") in appeals for merits reviews, which are to be heard during April and May 2012.

In its assessment of the effectiveness of the rate of return framework of the NGR, the AEMC has observed that no guidance is provided as to what factors should be considered in determining how the cost of equity is to be estimated, other than to specify a well accepted approach. Rule 87(2) of the NGR sets out guidance, however, in terms of its requirements that:

- ▶ the service provider be assumed to:
 - ▶ meet benchmark levels of efficiency;
 - ▶ use a financing structure that meets benchmarks standards as to gearing and other financial parameters for a going concern and reflects in other respects best practice;
- ▶ a well accepted approach that incorporates the cost of equity and the cost of debt, such as the Weighted Average Cost of Capital, is to be used; and a well accepted financial model, such as the Capital Asset Pricing Model, is to be used.

There is some risk that more extensive guidance and, in particular, the setting of specific parameter values in the rules or in subsidiary documents given recognition by the rules (such as the AER's proposed statements on the cost of capital) could lead to inconsistency between the guidance and the primary requirement that the rate of return satisfy a market test. It could lead to situations in which application of the framework would not lead to a rate of return which contributed to achievement of the NEO or the NGO.

Some guidance may, however, still be worthwhile to assist in focussing the regulator on models and approaches that are likely to produce outcomes consistent with a market test. That may increase the degree of certainty and predictability in the approach the regulator takes and thus in the outcomes observed.

Flexibility in the rate of return framework

Developments in financial markets since 2008 have highlighted to the FIG the need for flexibility in the rate of return framework.

The FIG supports the AEMC's finding that inflexibility is a major deficiency of the Chapter 6A framework for electricity transmission network service providers. The need for a stable framework within which consumer interests are carefully considered is acknowledged. However, an inflexible scheme which in some instances might prevent service providers from earning returns which reflect market conditions, and which does not allow them to raise the capital needed for investment in network maintenance and upgrading, is not in the long term interests of consumers and is to be avoided.

A more rigid framework may provide the benefits of stability and certainty in rate of return outcomes. However, those benefits must be assessed against the costs to service providers, and to consumers of electricity and natural gas, of rates of return which become inappropriate as market conditions change, or which are in error. In changing circumstances, or when errors are made in rate of return decisions, stability and certainty in rate of return outcomes are of limited value. Of value are clearly defined and stable rules which facilitate efficient adaptation to change, and the timely correction of error.

The FIG concurs with the AEMC's view that a rate of return framework should be flexible enough to allow consideration of new information or data sources, and should allow for merits review in the event of regulator error.

The AEMC has proposed various options for enhancing flexibility in the processes for determining rates of return in the NER and NGR. These options include greater choice of methodologies, use of ranges, removing the practice of locking-in parameter values at WACC reviews and removing barriers to changes in WACC parameter values from one review to another.

The FIG sees substantial merit in having a framework which is capable of responding to changing market conditions, practices and evidence. Nevertheless, the FIG acknowledges that a rate of return framework which accommodates greater flexibility may lead to further debate about regulatory decisions. There is, as the AEMC seems to recognise, need for a framework which balances flexibility to respond to change with sufficient guidance to contribute stability and certainty in the interests of both service providers and energy consumers.

The FIG accepts that finding the appropriate balance between guidance and flexibility is extremely difficult to do in practice. Trade-offs will be required if these competing objectives are to be achieved.

In its previous submission to the AEMC's Consultation Paper, the FIG highlighted that increased regulatory flexibility or discretion must be accompanied by appropriate levels of accountability.⁵ The FIG's views were framed in the context of arguments around the AER's proposals to effectively remove the ability for service providers to challenge the regulator's decisions on the rate of return via merits review appeals.

⁵ FIG, AEMC Consultation Papers: rule change proposals relating to the economic regulation of electricity and gas networks, 8 December 2011. See pages 14-18 and Appendix A in particular.

Notwithstanding that merits review is now being formally examined by the Standing Council on Energy and Resources, the evidence that we presented on the AER's track record in executing its discretions in relation to WACC, as borne out in the outcomes of appeals decided by the ACT, remains relevant to the AEMC's review. Specifically, the evidence that we presented in our earlier submission indicates that in relation to WACC, the AER's decisions have only been supported by the ACT about 30% of the time. The evidence suggests that the AER has consistently overstepped the bounds of, or misapplied, its discretion in making decisions on rates of return.

Based on this evidence, the FIG has reservations about whether providing the regulator with greater flexibility on choice of methodologies and other factors is an effective course of action. The evidence would appear to suggest that the AER has not exercised its existing discretions appropriately thus far.

On this basis, if any more discretion or flexibility is to be provided, it would be prudent to also include some boundaries around how that discretion is to be exercised. This could, for example, include guidance on the standard of evidence/logic required to support or reject a particular choice, and requirements for demonstrating how the exercise of discretion leads to an improved rate of return estimate.⁶

Potential lessons from the gas framework in establishing a market test

The AEMC concluded that the framework of the NGR had some merit. It provided a more flexible approach, which allowed the regulator to consider more information.

The FIG notes the AEMC's view that, in applying the gas framework, the AER and the ERA often make use of the approaches they apply to the electricity businesses they regulate. However, the FIG does not believe that this makes evaluation of the gas framework on a stand-alone basis difficult.

The difficulty is not one of evaluation. It is the fact that, in applying the gas framework, the AER and the ERA have, until recently, given little consideration to the specific requirements of that framework. Rather than apply the gas framework, the regulators have, inappropriately, imported thinking guided by the frameworks in electricity into gas regulatory decisions.

Nevertheless, in recent decisions made in accordance with the requirements of the NGL and the NGR, the AER has at least sought to assess whether the overall rate of return which it had determined:

- ▶ was commensurate with prevailing conditions in the market for funds in accordance with the requirement of Rule 87(1) of the NGR; and
- ▶ provided the service provider with an opportunity to recover at least its efficient costs in accordance with the requirement of section 24(2) of the NGL.⁷

The AER explained - in its April 2011 Amadeus Gas Pipeline Draft Decision - that, in establishing the rate of return:

⁶ The FIG's review of the outcomes of relevant appeals indicates that much of the ACT's criticisms of the AER revolve around inadequate logic.

⁷ These decisions included: : *Final decision - Public N.T. Gas Access arrangement proposal for the Amadeus Gas Pipeline*, July 2011, and *Draft decision - N.T. Gas Access arrangement proposal for the Amadeus Gas Pipeline*, April 2011; *Final decision - APT Allgas Access arrangement proposal for the Qld gas network*, June 2011, and *Draft decision - APT Allgas Access arrangement proposal for the Qld gas network*, February 2011; *Final Decision - Envestra Ltd Access arrangement proposal for the Qld gas network*, June 2011, and *Draft Decision - Envestra Ltd Access arrangement proposal for the Qld gas network*, February 2011; and *Final Decision - Envestra Ltd Access arrangement proposal for the SA gas network*, June 2011, and *Draft Decision - Envestra Ltd Access arrangement proposal for the SA gas network*, February 2011.

... “there is no precise answer that can be determined through the mechanistic application of a mathematical formula or parameter estimates developed in isolation. Parameter values that are unrepresentative of the best estimate commensurate with the market and the risk of providing the reference service would result in an inappropriate rate of return. In determining an appropriate rate of return the AER has reviewed a variety of evidence and arguments, and ultimately exercise its judgment to arrive at an outcome it determines best meets the revenue and pricing principles and the national gas objective. To arrive at this outcome, the AER has compared the rate of return against high level indicators for reasonableness. These indicators suggest that the rate of return chosen by the AER is at least sufficient to meet the objectives and requirements of the NGL and the NGR”.⁸

FIG members generally agree that “there is no precise answer that can be determined through the mechanistic application of a mathematical formula or parameter estimates developed in isolation”. They agree that a degree of judgement is required to arrive at the required rate of return outcome, but are of the view that the evidence and arguments put forward by the AER, and the high level indicators of reasonableness it has chosen, do not provide an adequate test of whether rates of return determined by the regulator are commensurate with prevailing conditions in the market for funds and the risks involved in providing services.

The relationships between the AER’s high level indicators and the requirements of Rule 87(1) and section 24(2) of the NGL are not obvious. It is not clear how the AER’s use of its high level indicators demonstrates that:

- ▶ the rate of return which it has calculated is commensurate with prevailing conditions in the market for funds and the risks involved in providing services; or
- ▶ the rate of return is such as to allow the service provider to recover at least its efficient financing costs.

If rule changes were to implement a rate of return framework with a clearer market test, guidance may be required. That guidance would not likely be limited to models and parameter values. Whatever models and parameter values are chosen, the resulting rate of return would still have to satisfy a market test. Rather, the guidance which may be required would be guidance on the way in which satisfying a market test is to be demonstrated.

That guidance may also need to address the role which is to be given to the assumption of a benchmark efficient service provider in rate of return determination. The AER and the ERA make specific and strong assumptions about the characteristics of the benchmark efficient service provider (for example, it is Australian owned and financed, and has a credit rating of BBB+) when applying the rate of return framework of the NGR.

These assumptions are not part of that framework; they are imported from the rate of return frameworks of the NER. The extent to which such assumptions can be made, their implications for rates of return are, however, circumscribed by the revenue and pricing principles. These principles, which are common to both the electricity and gas regulatory regimes, require a rate of return which allows recovery of the efficient costs of providing the services for which regulated tariffs are being determined, and require a return which is commensurate with the regulatory and commercial risks involved in providing those services. The assumption of the benchmark efficient service provider is necessary to ensure that candidate rates of return are in the right range. The determined rate of return is for the service provider and the specific circumstances in which it provides service.

⁸ Amadeus Gas Pipeline Draft Decision, page 65.

Retention of rights to merits review

The FIG fully endorses the AEMC's view that merits review remains an essential element of a rate of return framework, allowing any errors potentially made by the regulator to be corrected.

The reasons for our endorsement of this view are largely those set out above as part of our views on maintaining flexibility in the rate of return framework.

However, the FIG also points out that appeals for merits review have an important role in establishing and clarifying the meaning of complex rules such as those which are incorporated into rate of return frameworks.

The process of establishing and clarifying the meaning of new rules is an important part of ensuring that their application contributes to achievement of either the NEO or the NGO. Limiting or closing off the right of appeal may save costs to service providers and regulators in the short term, but impose long term costs on energy consumers because new rules have been interpreted and applied in ways which are ultimately not consistent with the long term interest of those consumers.

3.4 Responses to the AEMC's specific questions

| | |
|--------------------|--|
| <i>Question 20</i> | <i>Are some WACC parameter values more stable than others, and sufficiently stable to be fixed with a high degree of confidence for a number of years into the future? Would it be practical for periodic WACC reviews to cover only some parameters that are considered relatively stable in value, and require others to be determined at the time of each regulatory determination?</i> |
|--------------------|--|

Some WACC parameter values are typically more stable than others, and might be fixed for a number of years into the future by periodic WACC reviews and by the use of instruments such as the AER's proposed statement of the cost of capital. However, flexibility should be provided within a rate of return framework to allow early review and, if necessary, changes to those parameters, should changed market conditions clearly indicate that early review is required.

| | |
|--------------------|---|
| <i>Question 21</i> | <i>Would it be useful if the AER periodically published guidelines on its proposed methodologies on certain WACC parameters as opposed to undertaking periodic WACC reviews that locks in parameter values for future revenue/pricing determinations?</i> |
|--------------------|---|

Providing, within a rate of return framework, for the AER to periodically publish guidelines on its proposed methodologies on certain WACC parameters may be more effective than the undertaking of periodic WACC reviews. It may allow flexibility while continuing to provide the guidance which contributes to stability and certainty in the interests of both service providers and energy consumers. The FIG is not opposed to a SOCC provided it retains sufficient flexibility to meet a market test.

| | |
|--------------------|---|
| <i>Question 22</i> | <i>Given the uncertainty in estimating certain parameters, should the AER be required to produce the best possible values for all parameters or adopt a range from which it can choose a preferred estimate? Which WACC parameters are inter-related and should the rules recognise the inter-relationships between these parameters?</i> |
|--------------------|---|

If, as the FIG believes should be the case, a market test becomes the primary element of the rate of return framework, less reliance may need be placed on specific models and the values of the parameters to be used with those models. However, ranges of parameter values, and the inter-relationships between specific parameters may well have a role to play in demonstrating that a particular candidate rate of return satisfies the market test (i.e. as a cross check).

| | |
|--------------------|--|
| <i>Question 23</i> | <i>How do the outcomes with the persuasive evidence test applying at the time of the regulatory determinations in Chapter 6 of the NER differ from the NGR rate of return framework? Does the persuasive evidence test make it less likely that values of the WACC parameters will be updated as quickly under the NGR framework, or vice versa?</i> |
|--------------------|--|

Under an appropriate market test, both parameters and models must be capable of delivering a rate of return which is commensurate with prevailing conditions in the market for funds. The NGR rate of return framework does not incorporate a form of the persuasive evidence test found in Chapter 6 of the NER, and may with the presence of other tests allow WACC parameters to be quickly updated as financial market conditions change. However, the updating of parameter values in response to changed conditions is usually the outcome of regard for the evidence, debate and deliberation, which can lead to a protracted process.

There is a balance to be struck here between providing regulatory certainty and predictability, whilst meeting an appropriately defined market test.

| | |
|--------------------|--|
| <i>Question 24</i> | <i>How has the rate of return framework under the NGR worked alongside the NER frameworks?</i> |
|--------------------|--|

The rate of return framework under the NGR has not worked well alongside the NER frameworks. Neither the AER nor the ERA has generally sought to establish rates of return for gas pipeline service providers in accordance with the requirements of the NGR framework. The regulators have given little or no consideration to the fundamental requirement of that framework, the requirement that the rate of return is commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. Instead, they have taken the models and parameters values established and used for rate of return determination in the electricity transmission and distribution, and applied those models on the assumption that they would produce the required rate of return in gas. Only recently, and using very broad brush tests, has the AER sought to establish that its rate of return decisions in gas actually comply with the requirements of the NGR. No consideration has been given to whether a rate of return so established is consistent with the requirements of the revenue and pricing principles of the NGL, or whether it contributes to achievement of the NGL.

A specific instance of the rate of return framework under the NER guiding rate of return determination under the NGR is in the use of benchmarks. The AER and the ERA make specific and strong assumptions about the characteristics of the benchmark efficient service provider (for example, it is Australian owned and financed, and has a credit rating of BBB+) when applying the rate of return framework of the NGR. These assumptions are not part of that framework; they are imported from the rate of return frameworks of the NER.

| | |
|--------------------|---|
| <i>Question 25</i> | <i>Are there any concerns about the lack of guidance in the NGR on how the AER and the ERA will approach the rate of return decision? To what extent is the rate of return framework under the NGR influenced by the WACC approach adopted for the electricity sector for these regulators?</i> |
|--------------------|---|

See response to Question 24.

Question 26 Are there any reasons to adopt a WACC definition other than the vanilla post tax nominal definition that is used under the NER? Alternative proposals should explain why that alternative is likely to result in a better WACC estimate.

The FIG notes that the use of vanilla post-tax nominal definition of WACC that is currently prescribed in the NER is now widely applied by regulators in most jurisdictions. A significant amount of resources and investment has also been made in relation to putting this model in place by both regulators and service providers. Although the FIG could debate the merits of the approach in terms of its fit with incentive regulation and the need for it to be applied consistently over multiple price review periods to achieve its apparent objective (when the evidence appears to suggest that major rule changes are going to occur regularly), we do not consider that this debate would be particularly helpful at this stage.

Question 27 Should the AER/ERA be given discretion to consider models other than CAPM when estimating the required return on equity under the NGR? What prescription or principles could the rules contain to guide the way in which information from other models might be used to produce a better WACC estimate?

The FIG broadly supports enhancing the flexibility of the rate of return framework with regard to choice of models, including alternatives to the CAPM for estimation of the required rate of return on equity.

On what further guidance may be required, see response to Question 22.

Question 28 Are there any reasons why an appropriate WACC estimate cannot be provided to NSPs and gas service providers from a common WACC framework, without necessarily requiring the same parameter values to be adopted across the electricity transmission, electricity distribution and gas sectors?

The FIG is of the view that there are no technical impediments to the use of a common rate of return framework. That framework would give primacy to a market test for the rate of return, and would not require adoption of the same parameter values across the electricity transmission, electricity distribution and gas sectors.

Question 29 Which rate of return framework would best meet the key attributes identified? Are there other attributes that should be considered?

The AEMC determined that a good rate of return framework would:

- ▶ be based around estimating a rate of return for benchmark efficient firms;
- ▶ allow methodologies for parameters to be driven by principles and reflect current best practice;
- ▶ allow flexibility to deal with changing market conditions;
- ▶ recognise the inter-relationships between some parameter values; and

- ▶ create a framework of accountability for both the regulator and the electricity network or gas pipeline service provider in determining an appropriate rate of return.

The FIG concurs with three of these attributes:

- ▶ allowing methodologies for parameters to be driven by principles and reflect current best practice;
- ▶ allowing flexibility to deal with changing market conditions; and
- ▶ creating a framework of accountability for both the regulator and the electricity network or gas pipeline service provider in determining an appropriate rate of return.

However, the FIG is of the view that these attributes are subordinate to the rate of return framework having to deliver rates of return which contribute to achievement of the NEO and the NGO.

A framework which delivers rates of return which contribute to achievement of the NEO and the NGO would place a primary market test on the rate of return. Once that primary market test is required, less reliance needs to be placed on specific models, on the values of the parameters to be used with those models, and on the inter-relationships between particular parameter values.

Some guidance may, however, still be worthwhile to assist in focussing the regulator on models and approaches that are likely to produce outcomes consistent with a market test. This may provide more regulatory stability, transparency and certainty.

A good rate of return framework may use an estimate of the rate of return for a benchmark efficient firm, but it would not be “built around” estimating the rate of return for such a firm. The rate of return estimated for a hypothetical entity - the benchmark efficient firm - risks, in any specific instance, not promoting efficient investment in, and efficient operation and use of, electricity network or gas pipeline services in the long term interests of energy consumers. It risks not contributing to achievement of the NEO or the NGO.

Furthermore, the revenue and pricing principles of the NEL and the NGL require a rate of return which allows recovery of the efficient costs of providing the services for which regulated tariffs are being determined, and require a return which is commensurate with the regulatory and commercial risks involved in providing those services. The assumption of the benchmark efficient service provider is necessary to ensure that candidate rates of return are in the right range. The determined rate of return is, however, for the service provider and the specific circumstances in which it provides service.

4. Capex incentives and *ex-post* review

4.1 The AEMC's initial position

Our understanding of the AEMC's initial position in respect of capex incentives, including *ex post* review of capex, is as follows. This section only relates to electricity service providers.⁹

4.1.1 Matters on which the AEMC appears to have a firm position

The AEMC appears to have reached a relatively firm position on the following:

- ▶ rate of return issues should be addressed separately from capex incentive issues;
- ▶ the NER provide no incentive to overspend on capex relative to the regulatory allowance;
- ▶ there are timing incentive problems in respect of capex that are addressed for opex through the efficiency benefit sharing scheme ("EBSS"); and
- ▶ it does not support the AER's proposed 60/40 sharing mechanism for capex overspend.

4.1.2 Outstanding matters

In respect of outstanding matters, the AEMC notes that:

- ▶ capex overspend is not subject to any regulatory scrutiny, which creates a risk that it may be inefficient and that factors outside the rules may provide incentives for capex beyond the allowance;
- ▶ this is a deficiency and the rules could be enhanced to allow for some scrutiny of, or incentives relating to, actual expenditure that differs from the forecasts.¹⁰ In this regard, the AEMC notes the views of:
 - ▶ Prof. Yarrow - who argues that in the absence of a rationale for there being no supervision of expenditure above the allowance, there would appear to be a clear case for closing the gap; and
 - ▶ Prof. Littlechild - who considers that US experience suggests that *ex-post* reviews should not be ruled out, but notes that, in order to reduce cost and regulatory risk, there has increasingly been a move to pass-through arrangements, pre-approvals of major capex and price control re-openers.

The AEMC also notes that it is:

- ▶ seeking to understand the nature and causes of overspends, particularly given that there are some mechanisms already in place to protect NSPs from risks outside their control (i.e. the uncertainty regime);
- ▶ seeking to undertake further work to understand approaches adopted in other countries and by jurisdictional regulators in Australia to provide incentives for capex efficiency, and the strength and form of incentives created; and

⁹ Different issues arise for gas service providers, with the commercial requirements of NGR (e.g. Rule 79), making an EBSS mechanism inappropriate.

¹⁰ The deficiency would appear to relate to the lack of scrutiny and any proposed rule change would appear to relate to addressing this issue (rather than factors outside the rules), but the wording is somewhat ambiguous.

- ▶ reluctant to prescribe a detailed solution to the problems raised above, but would instead prefer to establish principles and allow the AER to develop a solution consistent with those principles.

4.2 Our comments on the AEMC's initial position

The FIG agrees with all the AEMC's initial positions in respect of the matters on which the AEMC appears to have a firm position.

However, the FIG is opposed to any *ex post* review of capex. This is simply because:

- ▶ there is no evidence of a problem, at least outside of governance issues;
- ▶ any incentive benefits of retaining the right to 'optimise' capex are likely to be outweighed by the increased risk it imposes on all proposed investments;
- ▶ that risk can only increase the returns required by investors to invest in regulated infrastructure, as the AER has previously acknowledged¹¹; and
- ▶ that risk is exacerbated by:
 - ▶ the asymmetry that it introduces into the regulatory process because the regulator can 'second guess' the investment decisions (to which it was a party to at the time), with the benefit of hindsight. It is not reasonable to expect hindsight will be ignored when such *ex post* judgements are made; and
 - ▶ FIG's concerns regarding the AER's performance in respect of its exercise of its discretion (as evidenced in the FIG's previous submission and the outcomes of the merits review activity observed).

The FIG notes that neither Prof. Yarrow nor Prof. Littlechild was necessarily advocating *ex post* review; rather it was presented as an alternative where there was a supervisory gap (as Prof. Yarrow described it). Prof. Littlechild noted that the existing incentives might be less effective in respect of government owned businesses (and also noted the evidence supported this), and suggested that alternative regulatory arrangements might be more appropriate for them. Both noted that *ex post* review is more widely used in US (rate of return) regulatory systems.

The evidence clearly shows, however, that no supervisory gap exists.

The FIG's submission to the AEMC's Consultation Papers showed that material overspending relative to the benchmarks is a phenomenon unique to government owned businesses in the electricity sector. The FIG's analysis showed that, in the previous round of regulatory determinations, the Victorian and South Australian distribution businesses, in aggregate:

- ▶ 'overspent' their capex allowances by 1%; and
- ▶ spent 10% less than their opex benchmarks.

By contrast, in the previous round of regulatory determinations, Government owned businesses 'overspent' on capex by 35% and on opex by 9%.¹² More broadly, the FIG provided significant evidence of the longer term network cost performance of the privately owned Victorian and South Australian businesses, which has been underpinned by strong out-performance on opex and capex.

¹¹ FIG, AEMC Consultation Papers: rule change proposals relating to the economic regulation of electricity and gas networks, 8 December 2011, page 59

¹² *Ibid.*, pages 56-57

This evidence does not appear to have been considered by the AEMC, perhaps in part because it does not accept there is an incentive to overspend and it is seeking to better understand the nature and causes of overspends.

The evidence suggests, however, that the introduction of *ex post* review of capex can only be:

- ▶ to address overspending that occurs for other reasons (i.e. governance issues);
- ▶ but, as a matter of broad principle the AEMC states “*First, regulation cannot compensate for weaknesses in corporate governance arrangements.*”¹³

The FIG believes the AEMC’s broad principle is entirely appropriate and should be applied in this case.

While the FIG is confident that any *ex post* mechanism would have limited impact on the businesses in which its members have interests, it creates a risk larger impact. That risk has a cost. In addition, making rule changes to address governance issues would be poor public policy, not only because it is unlikely to be effective, but also because it would create a precedent (and may encourage the regulator to adopt a similar approach in executing its role more broadly).

The FIG supports strengthening the incentive to optimise capex through the extension of the efficiency benefit sharing scheme (“EBSS”) to capex, and its members would accept the associated risks. Combined with service (e.g. reliability) standards and incentives, this provides the most appropriate and practical mix of incentives to deliver efficient levels of capex.

Such an approach would be consistent with incentive-based regulation, which the FIG believes is ultimately the best way to protect the long term interests of electricity consumers.

The potential alternative appears to be to introduce *ex post* review but reduce the risks associated with it through various mechanisms (e.g. pass-through arrangements, pre-approvals of major capex and price control re-openers). Moreover, the AEMC would only provide broad principles to guide the regulator’s solution. The FIG would be concerned with this approach because it will rely on more complex incentives, which will be driven by the detail of how the regulator executes the various mechanisms. In short, it is likely to result in weaker and more complex incentives and more intrusive regulation.

4.3 Responses to the AEMC’s specific questions

Question 7 In what circumstance would an NSP need to spend more than its allowance under the NER?

Circumstances can always arise where a NSP needs to spend more than its allowance to meet its service requirements. These could be for a variety of factors either within or outside a business’s control. With an appropriate approach to setting expenditure benchmarks (and underlying variables such as demand forecasts), any instances of overspend are likely to be rare, not highly material, and typically a function of factors within the NSP’s control.

The evidence of the performance of the privately owned businesses, as summarised above, supports this view.

¹³ AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Directions Paper, AEMC, 2 March 2012, Sydney. Page ii.

| |
|---|
| <p>Question 8 <i>What is the best option for dealing with the capex incentive issues identified in this paper?</i></p> |
|---|

As outlined above, in the FIG's view, the best solution would be to:

- ▶ develop an EBSS for capex to improve the incentive to avoid or defer capex, where it will not result in a degradation of service standards. It should be symmetrical, with service standards and incentives used to provide a counter-weight;
- ▶ not introduce an *ex post* capex review mechanism; and
- ▶ keep the uncertainty regime simple and limit it to factors clearly outside of the NSP's control.