ETSA Utilities, CitiPower and Powercor Australia

JOINT RESPONSE TO AER AND EURCC RULE CHANGE PROPOSALS (ERC0134 / ERC0135)

8 December 2011

Contents

GLOSSARY

Term	Description
2006 TNSP Draft Rule Determination	AEMC, *Draft Rule Determination, Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, 26 July 2006
2006 TNSP Rule Determination	AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006
2009 SORI	AER, *Electricity Transmission and Distribution Network Service Providers, Statement of the Revised WACC Parameters (Transmission), Statement of Regulatory Intent on the Revised WACC Parameters (Distribution),* May 2009
2009 SORI Decision	AER, *Final Decision, Electricity Transmission and Distribution Network Service Providers Review of the Weighted Average Cost of Capital (WACC) Parameters*, May 2009
2009 WACC Review	The review conducted by the AER in 2008-09 on the weighted average cost of capital parameters for electricity transmission and distribution businesses
ACCC	Australian Competition and Consumer Commission
ACT Distribution Determination	AER, *ActewAGL Distribution, Distribution Determination 2009-10 to 2013-14*, 28 April 2009
ActewAGL Distribution	A partnership between ACTEW Distribution Ltd and Jemena Networks (ACT) Pty Ltd
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AER Draft Rules	AER, *Rule Change Proposal, Economic Regulation of Transmission and Distribution Network Service Providers, AER's Proposed Changes to the National Electricity Rules, Part C - Draft Rules*, September 2011
AER Rule Change Proposal	AER, *Rule Change Proposal, Economic Regulation of Transmission and Distribution Network Service Providers, AER's Proposed Changes to the National Electricity Rules,* September 2011

AGS	Australian Government Solicitor
APT Allgas	APT Allgas Energy Pty Ltd
Aurora Energy	Aurora Energy Pty Ltd
BFM Regulations	*Electricity Safety (Bushfire Mitigation) Regulations 2003* (Vic)
Businesses	ETSA Utilities, CitiPower and Powercor Australia
capex	Capital expenditure
capex criteria	The capital expenditure criteria set out in clause 6.5.7(c) of the Rules
capex factors	The capital expenditure factors set out in clause 6.5.7(e) of the Rules
capex objectives	The capital expenditure objectives set out in clause 6.5.7(a) of the Rules
CCA	*Competition and Consumer Act 2010* (Cth)
CEG	Competition Economists Group
CEG DRP Rule Change Report	CEG, *Critique of AER rule change proposal, A report for ETSA Utilities, CitiPower and Powercor*, December 2011
CEPA	Cambridge Economic Policy Associates Ltd
CEPA Report	CEPA, *Rule Change Sub-Committee of Energy Users Association Australia, Estimating the Debt Margin, Final Report*, October 2011
CitiPower	CitiPower Pty
CitiPower Initial Regulatory Proposal	CitiPower, *Regulatory Proposal: 2011 to 2015*, 30 November 2009
CitiPower Revised Regulatory Proposal	CitiPower, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010
Country Energy	Now Essential Energy
DMIS	The demand management incentive scheme developed and published by the AER under clause 6.6.3 of the Rules as amended from time to time
DNSP	Distribution network service provider
DRP	Debt risk premium

EBSS	The efficiency benefit sharing scheme developed and published by the AER under clause 6.5.8 of the Rules as amended from time to time
ElectraNet Transmission Determination Final Decision	AER, *Final Decision, ElectraNet Transmission Determination 2008-09 to 2012-13*, 11 April 2008
ENA	Energy Networks Association
Energex	ENERGEX Ltd
Energex Initial Regulatory Proposal	Energex, *Regulatory Proposal for the period July 2010 - June 2015*, July 2009
Energex Revised Regulatory Proposal	Energex, *Revised Regulatory Proposal for the period July 2010 - June 2015*, January 2010
EnergyAustralia	Now AusGrid
Envestra	Envestra Ltd
Ergon Energy	Ergon Energy Corporation Ltd
Ergon Energy Initial Regulatory Proposal	Ergon Energy, *Regulatory Proposal to the Australian Energy Regulatory, Distribution Services for period 1 July 2010 to 30 June 2015, Ergon Energy Corporation Limited*, 1 July 2009
Ergon Energy Revised Regulatory Proposal	Ergon Energy, *Revised Regulatory Proposal to the Australian Energy Regulatory, Distribution Services for 1 July 2010 to 30 June 2015, Ergon Energy Corporation Limited*, 14 January 2010
ESA	*Electricity Safety Act 1998* (Vic)
ESCOSA	Essential Services Commission of South Australia
ETSA Utilities Initial Regulatory Proposal	ETSA Utilities, *Regulatory Proposal 2010-2015*, 1 July 2009
ETSA Utilities Revised Regulatory Proposal	ETSA Utilities, *Revised Regulatory Proposal 2010-2015*, 14 January 2010
EURCC	Energy Users Rule Change Committee of the Energy Users Association of Australia
EURCC Rule Change Proposal	EURCC, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt*, 17 October 2011
expenditure criteria	capex criteria and opex criteria
expenditure factors	capex factors and opex factors

expenditure objectives	capex objectives and opex objectives
F&A Paper	A framework and approach paper prepared and published by the AER under clause 6.8.1 of the Rules
GFC	Global financial crisis
Integral Energy	Now Endeavour Energy
JEN	Jemena Electricity Networks (VIC) Ltd
JEN Initial Regulatory Proposal	JEN, *Jemena Electricity Networks (Vic) Ltd Regulatory Proposal 2011-15*, 30 November 2009
JEN Revised Regulatory Proposal	JEN, *Jemena Electricity Networks (Vic) Ltd Revised Regulatory Proposal 2011-15*, 20 July 2010
JGN	Jemena Gas Networks (NSW) Ltd
Law	National Electricity Law set out in the schedule to the *National Electricity (South Australia) Act 1996*
MCE	Ministerial Council on Energy
MRP	Narket risk premium
NEO	The national electricity objective set out in section 7 of the Law
New South Wales Distribution Determinations	AER, *Country Energy Distribution Determination 2009-10 to 2013-14*, 28 April 2009; AER, *EnergyAustralia Distribution Determination 2009-10 to 2013-14*, 28 April 2009; and AER, *Integral Energy Distribution Determination 2009-10 to 2013-14*, 28 April 2009
New South Wales DNSPs	Country Energy (now Essential Energy), Energy Australia (now AusGrid) and Integral Energy (now Endeavour Energy)
New South Wales DNSPs Review	Tribunal review proceedings File Nos 2, 4 and 6 of 2009
NSP	Network service provider
opex	Operating expenditure
opex criteria	The operating expenditure criteria set out in clause 6.5.6(c) of the Rules
opex factors	The operating expenditure factors set out in clause 6.5.6(e) of the Rules
opex objectives	The operating expenditure objectives set out in clause 6.5.6(a) of the Rules

Powercor Australia	Powercor Australia Ltd
Powercor Australia Initial Regulatory Proposal	Powercor Australia, *Regulatory Proposal: 2011 to 2015*, 30 November 2009
Powercor Australia Revised Regulatory Proposal	Powercor Australia, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010
Powerlink	Powerlink Queensland, part of Queensland Electricity Transmission Corporation Ltd
PwC	PricewaterhouseCoopers
Queensland Distribution Determinations	AER, *Ergon Energy Distribution Determination 2010-11 to 2014-15*, 4 May 2010 and AER, *Energex Distribution Determination 2010-11 to 2014-15*, 4 May 2010
Queensland Distribution Determinations Final Decision	AER, *Final Decision, Queensland Distribution Determination 2010-11 to 2014-15*, May 2010
Queensland DNSPs	Energex and Ergon Energy
Queensland Transmission Determination Draft Decision	AER, *Draft Decision, Powerlink Transmission Determination 2012-13 to 2016-17*, November 2011
RAB	Regulatory asset base
Regulations	*National Electricity (South Australia) Regulations* made under the Law
RPPs	The revenue and pricing principles set out in section 7A of the Law
Rules	National Electricity Rules
SCO	Standing Committee of Officials of the MCE
SOCC	Statement on the cost of capital
SORI	Statement of regulatory intent
South Australian and Queensland DNSPs Review	Tribunal review proceedings File Nos 2 to 4 of 2010
South Australian Distribution Determination	AER, *ETSA Utilities Distribution Determination 2010-11 to 2014-15*, 4 May 2010
South Australian Distribution Determination Draft Decision	AER, *Draft Decision, South Australia Draft Distribution Determination 2010-11 to 2014-15*, 25 November 2009 and AER, *Draft Decision - Appendices, South Australia Draft Distribution Determination 2010-11 to 2014-15*, 25 November 2009

South Australian Distribution Determination Final Decision	AER, *Final Decision, South Australia Distribution Determination 2010-11 to 2014-15*, May 2010
South Australian DNSP	ETSA Utilities
SP AusNet Transmission Determination Final Decision	AER, *Final Decision, SP AusNet Transmission Determination 2008-09 to 2013-14*, January 2008
SPI	SPI Electricity Pty Ltd
SPIAA	SPI (Australia) Assets Pty Limited
SPI Initial Regulatory Proposal	SPI, *SPI Electricity Pty Ltd Electricity Distribution Price Review 2011-2015, Regulatory Proposal, Public Version*, November 2009
SPI Revised Regulatory Proposal	SPI, *SPI Electricity Pty Ltd Electricity Distribution Price Review 2011-2015, Revised Regulatory Proposal*, July 2010
STPIS	The service target performance incentive scheme developed and published by the AER under clause 6.6.2 of the Rules as amended from time to time
Tasmanian Distribution Determination Draft Decision	AER, *Draft Distribution Determination Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011
Tasmanian DNSP	Aurora Energy
TNSP	Transmission network service provider
Transend Transmission Determination Final Decision	AER, *Final Decision, Transend Transmission Determination 2009-10 to 2013-14*, 28 April 2009
TransGrid Transmission Determination Final Decision	AER, *Final Decision, TransGrid Transmission Determination 2009-10 to 2013-14*, 28 April 2009
Tribunal	Australian Competition Tribunal
United Energy	United Energy Distribution Pty Ltd
United Energy Initial Regulatory Proposal	United Energy, *Regulatory Proposal for Distribution Prices and Services January 2011 - December 2015*
United Energy Revised Regulatory Proposal	United Energy, *Revised Regulatory Proposal for Distribution Prices and Services January 2011 - December 2015*
VBRC	Victorian Bushfires Royal Commission
VBRC Final Report	2009 Victorian Bushfires Royal Commission, *Final Report*, July 2010

Victorian Distribution Determinations	AER, *Final, CitiPower Pty, Distribution Determination 2011-2015*, October 2010; AER, *Final, Powercor Australia Ltd, Distribution Determination 2011-2015*, October 2010; AER, *Final, Jemena Electricity Networks (Victoria) Ltd, Distribution Determination 2011-2015*, October 2010; AER, *Final, SPI Electricity Pty Ltd, Distribution Determination 2011-2015*, October 2010 and AER, *Final, United Energy Distribution, Distribution Determination 2011-2015*, October 2010
Victorian Distribution Determinations Draft Decision	AER, *Draft Decision, Victorian Electricity Distribution Network Service Providers Distribution Determination 2011-2015*, June 2010 and AER, *Draft Decision, Victorian Electricity Distribution Network Service Providers Distribution Determination 2011-2015, Appendices*, June 2010
Victorian Distribution Determinations Final Decision	AER, *Final Decision, Victorian Electricity Distribution Network Service Providers Distribution Determination 2011-2015*, October 2010 and AER, *Final Decision - Appendices, Victorian Electricity Distribution Network Service Providers Distribution Determination 2011-2015*, October 2010
Victorian DNSPs	CitiPower, JEN, Powercor Australia, SPI and United Energy
Victorian DNSPs Review	Tribunal review proceedings File Nos 6 to 10 of 2010
WACC	Weighted average cost of capital

1 INTRODUCTION

On 29 September 2011, the AER submitted to the AEMC a raft of proposed changes to the Rules governing the economic regulation of electricity and gas NSPs. The AER sought changes to the Rules to address problems it identified with:

- the capex and opex assessment framework, including incentive arrangements in respect of capex, in electricity;
- the cost of capital (or WACC) provisions in both gas and electricity; and
- the efficiency of the regulatory decision-making process.

On 18 October 2011, the EURCC submitted further proposed changes to the Rules relating to the calculation of the cost of capital (in particular, the return on debt) for electricity NSPs under Chapters 6 and 6A of the Rules.

This Response constitutes the joint response to the AER Rule Change Proposal and EURCC Rule Change Proposal of ETSA Utilities, CitiPower and Powercor Australia. As the Businesses are DNSPs regulated under Chapter 6 of the Rules, the Response deals primarily with the proposed changes to that Chapter of the Rules.

At the outset, the Businesses consider that it is premature to be embarking on an extensive review of the regulatory framework of the nature proposed by the AER. It is only three years since the Chapter 6 provisions were introduced as the regulatory framework governing DNSPs (with changes being made to the TNSP regulatory framework to reflect the differences in the nature of the transmission and distribution networks). To review and fundamentally change the regulatory framework at this stage is undesirable for two key reasons:

1 Revisiting significant aspects of regulatory framework after the Rules have been in place for only three years (that is, less than the length of one regulatory control period) undermines regulatory certainty and predictability. Given the long term nature of investments in the energy sector, fundamentally shifting the framework for the regulation of NSPs on an ad hoc, overly frequent basis will undermine investor certainty, compromising NSPs' ability to make investments in the network.

2 The effectiveness of the current regime can only be tested after a full regulatory cycle is completed and actual performance is known across several jurisdictions. The regulatory control period in respect of which the first distribution determinations were made by the AER (being the New South Wales Distribution Determinations) is only half way through and it is premature to attempt to draw conclusions as to the operation of the current Rules on the basis of the partial experience of only one jurisdiction, which was subject to transitional arrangements that vary in parts from the final version of Chapter 6 of the Rules. The first determinations made under Chapter 6 in its complete form relate to ETSA Utilities, Ergon Energy and Energex and these determinations are only in their second year of operation.

Notwithstanding this, the Businesses accept that there is potential for improvement to the process-related aspects of the regulatory framework and associated stakeholder engagement.

The remainder of this Response is structured in the following manner:

- section 2 provides a **summary of the Businesses' overall position** on the AER and EURCC Rule Change Proposals, addressing the four key questions posed by the AEMC in its consultation paper of 20 October 2011 regarding the AER Rule Change Proposal;

- section 3 summarises the Businesses' response to the AER Rule Change Proposal in respect of the **capex and opex framework**. Annexure A provides detailed comments and evidence in support of the Businesses' response to this aspect of the AER Rule Change Proposal;

- section 4 summarises the Businesses' response to the AER and EURCC Rule Change Proposals in respect of the **determination of the rate of return**. Annexure B provides detailed comments and evidence in support of the Businesses' response to this aspect of the Rule Change Proposals;

- section 5 summarises the Businesses' response to the AER Rule Change Proposal in respect of the **regulatory decision-making process.** Annexure C provides detailed comments and evidence in support of the Businesses' response to this aspect of the Rule Change Proposal; and

- section 6 summarises the Businesses' response to the AER's proposed **transitional arrangements** in so far as they relate to Victoria and South Australia.

Where appropriate, the Businesses have made suggested drafting amendments to the AER Draft Rules. These changes are shown in text boxes after the summary sections in each of the detailed Annexures A, B and C referred to above. The AER's amendments to the current Rules are shown in blue text with single underline or single strike through as relevant. The Businesses' proposed amendments are shown in red text with a double underline or double strike through as relevant. Where the Businesses have proposed a change to reverse an AER change (that is, to reinstate text that was deleted by the AER or to delete text that was added by the AER), this is shown in green text. While the Businesses have endeavoured to provide specific drafting to assist the AEMC, the Businesses wish to make it clear that, in the time available, a comprehensive review of the workability of all of the drafting amendments proposed by the AER has not been conducted.

The Businesses have also provided the AEMC with a CD containing a copy of each of the documents relied on in this Response. A list of these documents is included at Annexure D. Where confidentiality is claimed over a document, this is identified in Annexure D. The Businesses request that the AEMC disclose any confidential information provided to it with this Response only with the Businesses' prior written consent.

2 SUMMARY OF THE BUSINESSES' OVERALL POSITION

This section provides the Businesses' overarching comments on the AER and EURCC Rule Change Proposals. It addresses the key themes highlighted by the AEMC in its consultation paper of 20 October 2011 regarding the AER Rule Change Proposal, being the extent of the problem as characterised by the AER, the balance between prescription and discretion in the proposed Rules (including whether the AER could achieve the same outcome by exercising the discretions it currently has under the Rules) and whether there are more preferable solutions to any problems than the solutions proposed by the AER.

2.1 THE PROBLEM

The Businesses do not agree with the extent of the problem with the current Rules as outlined by the AER and consider that the AER has in the main failed to substantiate the need for a change to the current Rules. Specifically:

- The AER has not provided compelling evidence that the capex and opex framework 'delivers inflated forecasts of capital and operating expenditure and fails to provide sufficient incentives for efficient expenditure'. The AER acknowledges that there are many reasons network prices, are increasing, including, higher reliability standards, electricity networks with aging assets that need replacing, continued increases in peak demand with declining sales growth, the increasing cost of funds and the pass through of costs associated with government renewable energy policy initiatives. The Businesses consider that the AER's view that increasing network prices are a consequence of a deficiency in the capex and opex framework is not substantiated.

- Contrary to the AER's asserted deficiencies in the Chapter 6 framework for WACC determination, the requirement under Chapter 6 of the Rules for a distribution determination to which a SORI is applicable to be consistent with that SORI unless there is persuasive evidence justifying a departure has been highly effective in minimising debate in distribution determination processes on the application of SORI outcomes and in minimising Tribunal reviews of those determinations in respect of those elements of WACC estimation that were the subject of the SORI. Indeed:

    - in those distribution determination processes to which the 2009 SORI applied, the departures from that SORI ultimately proposed by the relevant DNSPs have been confined to the value and estimation of gamma; and

    - the Tribunal reviews of AER decisions in distribution determinations on elements of WACC estimation that were the subject of the 2009 SORI have been wholly confined to the estimation of gamma.

- Further, as noted above, in all but a small number of cases relating to process, no proper assessment of the performance of the current Rules can be performed. Without actual data across a complete regulatory control period and across jurisdictions, limited conclusions can be drawn as to the effectiveness of the regime.

In so far as the AER raises concerns regarding the divergence between the provisions in Chapter 6 and Chapter 6A, the Businesses observe that often this was the consequence of a deliberate decision on the part of the SCO, and the AER has not presented any evidence as to why the conclusions reached by the SCO should now be set aside.

2.2 PRESCRIPTION AND DISCRETION

The Businesses support the level of prescription in the existing Rule provisions.

In its Rule Change Proposal, the AER has proposed to confer on itself significantly greater discretion in making distribution determinations. Most notably:

- The AER's proposed Rule changes remove all those existing requirements and limitations that establish the 'propose-respond' model that is a fundamental tenet of the existing expenditure forecasting framework under the Rules. The Rule Change Proposal would, if made, confer on the AER discretion to determine expenditure forecasts without being

required to start with the NSP's proposal, according that proposal no greater role in the process than any other stakeholder submission. As a consequence, the AER's proposed framework delivers a heightened risk of regulatory failure.

- The AER's proposed changes would also confer on it unfettered discretion with respect to the methodology for and estimation of the cost of debt, which would, in turn, expose NSPs to increased and unnecessary risk and uncertainty. As the certainty and predictability of the future rate of return is critical to the creation of incentives for, and promotion of, efficient investment, this AER discretion can be expected to discourage efficient investment.

The AER Rule Change Proposal therefore directly conflicts in many instances with the deliberate policy considerations of the MCE, AEMC and SCO in developing the provisions of the Rules in their current form. In particular, by seeking to confer additional discretion on itself, the AER is seeking to blur the distinction between 'rule maker' and 'rule enforcer', explicitly adopted by the MCE in establishing the national framework for the regulation of electricity.

The AER Rule Change Proposal also contains a number of instances in which it is attempting to migrate back to previous jurisdictional arrangements, which were considered and discarded through the Rule making process.

In addition to the conferral of additional discretion on the AER, a number of aspects of the AER Rule Change Proposal also seek to reduce the accountability and scrutiny of the exercise of its discretion. For example, one of the key effects of the AER's proposed convergence of the framework for WACC determination under Chapters 6 and 6A of the Rules, based on the existing framework in Chapter 6A, is to remove the availability of merits review of the AER's WACC decision making for distribution.

Neither the AER Rule Change Proposal's conferral of additional discretion on the AER nor its removal of the exercise of that discretion from regulatory scrutiny by the Tribunal is appropriate in circumstances where Tribunal determinations to date demonstrate the real potential for regulatory error by the AER and the resultant need for the Rules to provide guidance to the AER in the exercise of its discretion and for the regulatory accountability and scrutiny delivered by merits review. Against this background, the Businesses submit the AEMC should be wary of making Rule changes that confer additional discretion on the AER or reduce the potential for the correction of regulatory error through the availability of merits review.

The AER's request for additional discretion in the assessment of capex and opex proposals stems from its concern that there are significant limitations on the regulatory judgment that can be exercised under the existing regime. However, this concern has not been borne out in practice. In particular, the AER has rejected capex and opex proposals and substituted its own amounts in every determination it has made to date.

2.3 THE SOLUTION

The Businesses submit that the existing Rule provisions in most instances strike the right balance between prescription and discretion and thus no change to the Rules are necessary. The AER has not presented sufficient evidence to justify a departure from the existing Rules, or demonstrate that its proposed form of the Rules would contribute to a more effective achievement of the NEO and the RPPs. Just as the AER requires NSPs to put forward material in support of their regulatory proposals, the AER should be required to present evidence to support its assertions that its Rule Change Proposal promotes the NEO and is consistent with the RPPs.

The Businesses acknowledge that the AER has raised some valid points, particularly with respect to the regulatory process, and have drafted suggested amendments to the AER Draft Rules if it is considered that the AER Draft Rules do not promote the NEO, or are not consistent with the RPPs. While the Businesses have endeavoured to provide specific drafting to assist the AEMC, the Businesses wish to make it clear that, in the time available, a comprehensive review of the workability of all of the drafting amendments proposed by the AER has not been conducted.

The Businesses urge the AEMC to carefully consider the AER Proposed Rule Change, including the evidence put forward by the AER and interested parties, before making any change to the existing provisions. Significant investment decisions have been, and will be, made on the basis of the regulatory framework and regulatory outlook, and as such the AER Rule Change Proposal warrants transparent, balanced and careful consideration.

3 CAPEX AND OPEX FRAMEWORK

This section summarises the Businesses' response to the AER Rule Change Proposal in respect of the capex and opex framework. Annexure A provides the Businesses' detailed comments and evidence in support of the Businesses' response to this aspect of the AER Rule Change Proposal.

3.1 SETTING ESTIMATES OF REQUIRED EXPENDITURE AND CONSEQUENTIAL AMENDMENTS TO PROCESS MATTERS

AER Rule Change Proposal

The AER proposes the replacement of the existing Rule requirements[1] (under which it is required to accept an NSP's forecast of required opex or capex if the AER is satisfied that the total of the forecast for the regulatory control period reasonably reflects the opex or capex criteria respectively) with a requirement for the AER to determine the total of the forecast of required opex or capex of the NSP that 'the AER considers would meet the efficient costs that a prudent [NSP] would require to achieve' the opex or capex objectives.[2]

The AER contends that the existing framework for setting forecasts of capex and opex delivers 'systematically inflated expenditure forecasts'[3] because NSPs submit forecasts at the upper end of 'the "reasonable" range', and the AER is precluded from amending forecasts proposed by NSPs where there are lower forecasts within that range.[4]

The AER asserts that this problem is exacerbated for distribution as the AER may amend the DNSP's expenditure forecasts 'only to the extent necessary' to enable them to be approved in

[1] Clauses 6.5.6(c)-(d), 6.5.7(c)-(d), 6.12.1(2)-(4), 6A.6.6(c), 6A.6.6(d), 6A.6.7(c)-(d), 6A.14.1(1)-(3) of the Rules and Chapter 10 definitions of 'operating expenditure criteria' and 'capital expenditure criteria'; AER Draft Rules, pp23, 25, 48-49, 88, 91, 116-117, 144-145.

[2] AER Draft Rules, pp23, 25, 88, 91 (proposed clauses 6.5.6(c), 6.5.7(c), 6.12.1(2), 6.12.1(3), 6.12.1(4), 6A.6.6(c), 6A.6.7(c), 6A.14.1(1)).

[3] AER Rule Change Proposal, p28. See also pp12, 19.

[4] AER Rule Change Proposal, p13. See also pp25, 27-28.

accordance with the Rules with the consequence that the forecasts determined by the AER are necessarily at the top of that range.[5]

The AER further asserts that, as it is also required under Chapter 6 to determine substitute forecasts 'on the basis of' the NSP's current regulatory proposal, it must determine those substitute forecasts 'in the same manner as determined by the DNSP in their proposal', which, in turn, generally requires the AER to undertake a 'line by line assessment' of the NSP's 'bottom up' calculation of its forecasts.[6]

Businesses' Response

The existing Rule requirements for the AER to accept an NSP's expenditure forecasts if those forecasts 'reasonably reflect' efficient, prudent and realistic expenditure are the result of a deliberate and well considered policy decision by the AEMC.

The proposed Rule changes would give rise to a fundamental change to the existing framework for the setting of expenditure forecasts and should only be made if there is a material deficiency in that framework that has been substantiated by robust evidence following thorough consideration.

The Businesses do not agree with the AER's proposed Rule changes and consider that the AER's position is not supported by the evidence available to date.

The rejection by the AER, in its transmission and distribution determinations to date, of *every* NSP forecast of opex and capex discloses that the existing framework has not operated to restrict the AER's ability to reject NSPs' expenditure forecasts.[7] The fact that, in those determinations, the AER's substitute expenditure forecasts have generally been higher than actual expenditure incurred by NSPs in the previous period, is explained by a number of matters such as ageing assets and increased peak demand, and does not support the AER's contention that the substitute forecasts have been 'inflated' or represent the upper end of a 'reasonable' range of efficient, prudent and realistic expenditure.

The AER's rationale for removing the existing Rule requirements is also premised on the Rules being interpreted as precluding it from rejecting an NSP's forecasts where those forecasts are within the 'reasonable' range of estimates of efficient, prudent and realistic expenditure. However, this premise is inconsistent with recent Tribunal comments, and the AER's own contentions before the Tribunal, on the correct interpretation of these requirements.[8]

The Businesses also point out that the risk of 'systemically inflated forecasts' does not exist in respect of opex forecasts given the AER's 'revealed cost' approach to assessing and determining opex forecasts.

The AER's assertion that it is required to determine substitute forecasts 'in the same manner as determined by the DNSP in their proposal' is inconsistent with the Tribunal's interpretation and application of this requirement.[9] Similarly, while the AER asserts this requirement also requires it to

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[5] AER Rule Change Proposal, pp13, 25-26, 28-29.

[6] AER Rule Change Proposal, pp13, 26, 29.

[7] Details of the AER's decisions to date are set out in section A.1 of Annexure A.

[8] See section A.1 of Annexure A for further details (from p39).

[9] See section A.1 of Annexure A (p44).

undertake a 'line by line assessment' of the NSP's 'bottom up' calculation of its forecasts, the Businesses consider such a careful and thorough assessment to be desirable and consistent with the intent of the Rules. The Businesses disagree with the consequences said by the AER to flow from the requirement to conduct such a 'line by line assessment'.

The rationale for the original AEMC policy decision remains valid and the evidence to date does not support the AER's propositions. The Businesses consider that it is premature to revisit that rationale and the resultant Rule requirements until information for at least one complete cycle of regulatory control periods is available which will show how NSPs' actual expenditure compares to expenditure forecasts in transmission and distribution determinations made under the existing Rule framework.

The Businesses' detailed response to this Rule change proposal is set out in section A.1 of Annexure A to this Response.

3.2 EXPENDITURE OBJECTIVES, FACTORS AND CRITERIA

AER Rule Change Proposal

The AER considers that the expenditure criteria are no longer required under its proposal for the expenditure assessment framework, discussed in section 3.1 above. Instead, the AER proposes that the first and second of the expenditure criteria, relating to efficiency and prudency, be incorporated in its proposed statutory test for forecast expenditure. However, in incorporating the second expenditure criterion relating to prudency in its proposed statutory test, the AER's proposed statutory test for expenditure forecasts refers only to the costs that the hypothetical prudent NSP would require without the existing qualifying requirement that appears in that expenditure criterion to consider the prudent NSP 'in the circumstances of the relevant [NSP]'.

The AER also proposes a number of amendments to the expenditure factors. These amendments relevantly include:

- rendering the expenditure factors permissive rather than mandatory considerations (i.e. factors to which the AER 'may, as it considers appropriate', rather than 'must', have regard); and
- in relocating the expenditure factors relating to the information, submissions and analysis to which the AER is to have regard to the Rule provisions relating to the making of determinations, removing the existing qualification on the 'analysis undertaken by or for the *AER*' to which it is to have regard by reference to publication of that analysis before the final determination is made.

Businesses' Response

The Businesses disagree with the aspects of the AER Rule Change Proposal in respect of the expenditure criteria and expenditure factors described above.

First, the Businesses consider that the 'circumstances of the relevant [NSP]' qualification on the existing expenditure criterion relating to the costs that a prudent operator would require to achieve the expenditure objectives should be retained. If (contrary to the submissions of the Businesses in section 3.1 above) the AEMC is minded to make the AER's proposed changes to the expenditure assessment framework, the Businesses submit that the statutory test for expenditure forecasts proposed by the AER should be amended so as to retain this aspect of the existing expenditure criteria.

The requirement to take into account 'the circumstances of the relevant [NSP]' in determining the efficient and prudent costs required to achieve the expenditure objectives is critical to ensuring that the AER considers the operating environment of the relevant NSP, which environment is the key determinant of its cost structure. In the absence of this requirement, it would be open to the AER to determine on an expenditure forecast that bears no relationship to the expenditure required by that NSP, acting efficiently and prudently, to achieve the expenditure objectives.

While the AER asserts the existing requirement to take into account the NSP's circumstances may limit its ability to apply comparative analysis and benchmarking and may result in a tension with the identification of efficient costs, the Businesses observe that:

- the AER has undertaken benchmarking in its distribution determinations to date and any reduced weight accorded to that benchmarking has been accorded by the AER to its concerns with the inherent limitations of benchmarking techniques and the availability and methods of standardisation of input data and not to this Rule requirement;[10] and

- the tension referred to by the AER exists between the identification of efficient costs and the requirement to consider the costs required by a prudent operator and is, thus, inherent in the AER's proposed statutory test for expenditure forecasts, and in any event these tensions are already a matter within the AER's regulatory judgment.

Secondly, the Businesses strongly believe that the AER should continue to have a mandatory obligation to consider the expenditure factors rather than be free to decide at its discretion which of these factors to consider.

The establishment of an obligation, rather than a discretion, for the AER to have regard to the expenditure factors was the subject of express consideration by the AEMC and the result of a deliberate policy decision. The obligatory consideration of the expenditure factors by the AER was intended by the AEMC to contribute to the guidance provided by the Rules on the AER's exercise of judgment in assessing expenditure forecasts. In circumstances where the AER has advanced no basis for, or explanation of, its proposal to change the expenditure factors from mandatory to permissive considerations, that proposal should be rejected. The AER's proposed amendments to render these factors permissive considerations should not be accepted.

Thirdly, the Businesses object to the AER's proposal for the imposition on it of an obligation to consider analysis undertaken by or for the AER in circumstances where that analysis has not been the subject of publication and consultation prior to the making of the final determination. This proposed obligation is inconsistent with the AER's obligations under common law and section 16(1)(b) of the Law to accord procedural fairness. It follows that the AER's proposed Rule obligation is inconsistent with the NEO and RPPs and may, if made, be rendered invalid by reason of its inconsistency with common law and the parent Act.

The Businesses are concerned that, even where the AER's obligation to have regard to its own analysis is confined to analysis published prior to the making of the final determination, the Rules would not preclude the AER from relying on analysis that has not been published. This is particularly so as there are instances in which the AER has failed to provide to the Businesses before

[10] For example, Appendices to the Victorian Distribution Determination Final Decision, Appendix H, pp94-116 (see, in particular, section H.3.1.3, p99); Appendices to the South Australian Distribution Determination Final Decision, Appendix I, pp357-70; South Australian Distribution Determination Draft Decision, p200.

or on making its final determinations analysis and calculations that were ultimately determinative of its decisions in those determinations.

For these reasons, the Businesses propose an alternative Rule change to:

- confine the AER's obligation to have regard to analysis undertaken by or for it in making draft and final determinations to analysis published prior to the making of the determination; and

- require the AER to publish any analysis undertaken by or for it that is relied on in making draft and final determinations for public comment prior to the making of those determinations.

The Businesses' detailed response to this Rule change proposal is set out in section A.2 of Annexure A to this Response.

3.3 CAPEX INCENTIVES, CONTINGENT PROJECTS AND CAPEX REOPENERS

AER Rule Change Proposal

The AER has expressed concern that the current approach to the roll forward of the RAB (i.e. that all actual capex is rolled in), under certain circumstances, creates incentives for DNSPs to incur capex in excess of the efficient level of capex. The AER is seeking to allow only 60% of any capex in excess of the AER's forecast capex in the distribution determination to be rolled into the RAB and proposes to introduce capex reopeners and contingent project provisions to ameliorate concerns that its approach would discourage efficient investment in the network.

Businesses' Response

As the AEMC would be aware, the decision to allow NSPs to roll all actual capex into the RAB was a deliberate policy decision, designed to ensure NSPs had appropriate incentives to invest in sufficient capacity to maintain service levels amid dynamic demand conditions.

The Businesses do not accept the AER's proposed Rule change.

The Businesses are strong supporters of incentive based regulation and agree that the incentives applied to capex under the current Rules are relatively low powered and could be improved. The Businesses note that the AER already has the power to introduce capex incentives under the existing EBSS Rule provisions. The Businesses maintain that the current criteria governing the development of the EBSS are those that promote the NEO and the RPPs and reject the AER's proposed Rule change as it would not promote the NEO and would be inconsistent with the RPPs. Specifically, the AER's proposed Rule change:

- is asymmetric, providing only penalties where there is overspend with no rewards for underspend, and does not provide continuous incentives to make efficiency gains throughout the regulatory control period, contrary to the existing provisions in the Rules governing the development of the EBSS;

- introduces penalties for NSPs for making efficient investment in the network where the actual level of efficient expenditure is higher than forecast, thereby potentially deterring efficient investment in the network;

- fails to take into account potential trade-offs between opex and service standards and any capex incentive regime; and

- locks a particular capex incentive regime into the Rules, rather than (as is the case with the other incentive schemes), allowing it to develop over time and vary as the other incentives facing the NSPs evolve.

The AER's suggestion that its proposal to introduce capex reopeners and contingent projects into distribution would address the disincentives to incur efficient capex that would arise under the AER's proposed Rule change is also rejected as the scope for those provisions to apply in a distribution context is extremely limited.

The Businesses' detailed response to this Rule change proposal is set out in section A.3 of Annexure A to this Response.

3.4 PASS THROUGH EVENTS

AER Rule Change Proposal

The AER proposed to introduce a 1% materiality threshold for DNSP pass through events, whereby a positive pass through event would only be considered material where the increase in costs exceeds 1% of the annual revenue requirement for the DNSP for that regulatory year. The 1% materiality threshold is the materiality threshold applied to TNSP pass through applications.

Businesses' Response

While the AER contends a materiality threshold is required to maintain incentives on an NSP to operate efficiently, the Businesses observe that this is inconsistent with two significant factors. First, the pass through regime is intended to provide NSPs with an opportunity to recover costs that are unexpected and outside of its control.[11] NSPs cannot seek to reduce expenditure where that expenditure is by its nature, unexpected and beyond their control. Secondly, even if it is assumed that DNSPs could reduce the costs associated with pass through events, the AER's suggestion that a materiality threshold is required cannot be reconciled with the fact that the AER is required, in making a cost pass through determination, to take into account the efficiency of the DNSP's decisions and actions in relation to the risk of the cost pass through event, including whether the DNSP has failed to take any action that could reasonably be taken to mitigate the associated costs.[12] Any failure by the DNSP to move to mitigate its losses would no doubt impact on the level of costs that the AER determines can be passed through by the DNSP.

Nonetheless, the Businesses are generally supportive of a Rule change to provide greater certainty for stakeholders on the materiality threshold for the pass through regime in Chapter 6. The Businesses agree that a materiality threshold enshrined in the Rules would reduce the administrative costs associated with determining what such a materiality threshold should be.[13]

The Businesses reject the AER's proposed 1% materiality threshold on the basis that:

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[11] 2006 TNSP Rule Determination, p104.

[12] Clause 6.6.1(j)(3) of the Rules.

[13] This includes the development of any guidelines as to the AER's likely approach to determining materiality in the context of possible pass through events pursuant to clause 6.2.8(a)(4) of the Rules and responding to stakeholder submissions on materiality during the distribution determination review process (including at the F&A Paper, draft determination and final determination stages).

- transmission and distribution networks differ such that the same 1% materiality threshold should not be applied to both networks. As was recognised by the SCO at the time Chapter 6 was developed,[14] transmission capex is lumpier and more strongly influenced by individual projects than distribution capex. The likely cost impact on distribution networks from any one event is likely to be smaller than on transmission networks, and thus the same materiality threshold should not be applied; and

- a materiality threshold of 1% of the annual revenue requirement is overly onerous and would frustrate the intent of the pass through regime in the distribution context. The AER's proposal represents a significant increase in the existing materiality threshold in the Rules (which is, that the impact must be 'material' in the ordinary sense of the word). This has the effect of significantly increasing the risk to DNSPs associated with unforeseen events, contrary to the intent of the pass through regime and the NEO and the RPPs.[15]

The Businesses instead propose a materiality threshold in the Rules of $1 million for each pass through event. Such a change to the Rules would increase certainty for stakeholders around what is material for the purposes of the pass through provisions and reduce the administrative costs associated with determining what such a materiality threshold should be, but at the same time avoid the adverse cost recovery consequences of the AER's proposed threshold, thereby promoting the NEO and the RPPs.

The Businesses' detailed response to this Rule change proposal is set out in section A.4 of Annexure A to this Response.

3.5 EXCLUDING RELATED PARTY MARGINS

AER Rule Change Proposal

The AER proposed a Rule change to provide that any 'related party margins' and 'capitalised overheads' included in the RAB must not exceed the amounts determined in accordance with how related party margins and capitalised overheads were included in the total forecast capex in the distribution determination for the previous control period.

Businesses' Response

The Businesses acknowledge the AER's concern that under the current Rules there may be scope for actual capex incurred in a regulatory control period to include related party margins that are not efficient, and accept that a change in the Rules may be desirable. The Businesses are concerned, however, that the AER's proposed Rule changes are ambiguous and accordingly lack the certainty necessary to encourage efficient investment in networks.[16]

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[14] SCO, *Changes to the National Electricity Rules to establish a national framework for the economic regulation of electricity distribution, Explanatory material*, April 2007, pp53-54.

[15] The increased risk associated with greater exposure to unforeseen events (and the additional compensation that would be required as a result) was recognised by the AEMC in its 2006 TNSP Rule Determination (p104).

[16] Specifically, the Businesses are concerned that the words 'Any amounts of *related party margins* and capitalised *overheads* included in the total capital expenditure must not exceed the amounts determined in accordance with how *related party margins* and capitalised *overheads* were included in the total of the forecast capital expenditure determined in the distribution determination for the previous control period' in proposed clause S6.2.1(e)(1) of the AER Draft Rules are ambiguous.

In particular, the Businesses are concerned that the proposed Rule change may unreasonably limit the expenditure that may be rolled into the RAB to the actual amount as determined in the distribution determination (rather than to an amount that is determined by reference to the framework used to assess, or policies underpinning, the forecast amounts at the distribution determination stage). The Businesses consider that such a limitation is inconsistent with the NEO and the RPPs as it potentially strands efficiently incurred costs. It does this by ignoring the dynamic nature of business and market conditions that mean the expenditure allowances established in the distribution determination are rarely, if ever, met. Examples and evidence in support of this proposition are set out in section A.5 of Annexure A to this Response.

If the AEMC considers that a Rule change is desirable, the Businesses submit that the Rules should provide for:

- related party margins to be included in the RAB where they would be considered efficient under the AER's framework for determining whether such margins are efficient in the previous distribution determination; and

- capitalised overheads to be included in the RAB where they are allocated consistently with the capitalisation policy in place at the time of the AER's previous distribution determination.

This is a more flexible approach, which allows for changing market and business conditions and requires the AER to properly consider the prudency and efficiency of the actual expenditure incurred. By linking the assessment to be undertaken to the previous distribution determination, the Businesses' proposed Rule change would give the NSPs greater certainty as to whether capex incurred will be included in the RAB.

The Businesses' detailed response to this Rule change proposal is set out in section A.5 of Annexure A to this Response.

3.6 OTHER INCENTIVE SCHEMES

AER Rule Change Proposal

The AER proposed Rule changes to give itself discretion to create new incentive schemes to apply to DNSPs where it considers there are benefits to end users or customers arising from the application of the incentive scheme or schemes to DNSPs.

Businesses' Response

The Businesses are strong supporters of incentive based regulation and are not opposed to the introduction of further incentive schemes if appropriately designed.

The Businesses do not address in this Response whether the AER should be given a general discretion to introduce new incentive schemes. However, in the event the AEMC is minded to introduce such a discretion, the Businesses observe that the AER's proposed Rule changes would not promote the NEO or the RPPs as they do not offer sufficient certainty or clarity.

The AER's proposed Rule changes depart from the level of prescription in the Rules and the level of discretion afforded to the AER that that has been determined by rule makers to be the level that

promotes the NEO.[17] The AER's proposed Rule changes shift the balance that was originally struck by the AEMC and transfers additional power from the AEMC to the AER. Thus, if the AEMC concludes that the AER should be given the power to introduce new incentive schemes, the AEMC should supplement the AER's proposed decision-making criteria to ensure greater clarity, transparency and predictability in the regulatory framework in order to mitigate the potential for adverse impacts on investment. The Businesses submit that the following criteria should apply to any AER power to create new incentive schemes:

- the Rules should require any incentive scheme to be symmetric in nature, consistent with the policy objectives underlying the inclusion of this criteria in respect of the development of the EBSS under the Rules;[18]
- the desirability of incentive schemes that are simple to administer. Schemes that are administratively difficult to implement or interpret are likely to result in the management of NSPs ignoring the scheme, thereby reducing the impact the incentive scheme will have on actual outcomes;
- the desirability of ensuring that financial or non-financial targets set by the scheme do not put the safe and reliable operation of the network at risk. While the AER identified this as one of the matters the AER must have regard to in its Rule Change Proposal, this was not reflected in the AER Draft Rules; and
- any regulatory obligation or requirement to which the DNSP is subject.

The Businesses' detailed response to this Rule change proposal is set out in section A.6 of Annexure A to this Response.

3.7 TREATMENT OF SHARED ASSETS

AER Rule Change Proposal

The AER proposed changes to the Rules to introduce regulated revenue or control mechanism adjustments for situations where assets in the RAB are used to provide services other than standard control services.

Businesses' Response

The Businesses accept the principle that where the assets used to supply standard control services are shared between these and other services, gains to the NSP from non-standard control services should be shared with standard control services customers. However, the Businesses submit that the AER should not be provided with an unfettered discretion to introduce such adjustments; clear criteria should be enshrined in the Rules governing the AER's discretion to ensure transparency and certainty and thereby encourage efficient use of the assets (to reduce overall costs to standard control

[17] For instance, the Rules codify the object and nature of each of the incentives schemes that can be implemented by the AER and set out specific criteria that have to be applied in creating those schemes: clauses 6.5.8, 6.6.2 and 6.6.3 of the Rules.

[18] 2006 TNSP Rule Determination, p96. The requirement to provide for the symmetric treatment of efficiency gains in the distribution context is reflected in clause 6.5.8(a) of the Rules.

services customers), consistent with the NEO and the RPPs. The inclusion of specified criteria where the Rules confer discretion on the AER has been recognised by the AEMC.[19]

For instance, any new provision adopted by the AEMC should explicitly state that any framework adopted by the AER is to provide for the fair sharing of the profits from the provision of services other than standard control services using assets forming part of the RAB between the DNSP and the users. Expressly identifying the object and nature of the scheme would be consistent with the approach adopted elsewhere in the Rules, for example, in the provisions governing the EBSS, STPIS and DMIS.[20] The Businesses also consider that the Rules should require the AER to have regard to:

- the need to maintain incentives for DNSPs to engage in unregulated activities that utilise shared standard control services assets;
- the need to offer rewards to compensate for the relative risks borne by the DNSPs and users;
- the need to ensure the benefits to users associated with any sharing of gains materially exceed the costs of regulatory oversight; and
- any other adjustment or control mechanism providing for the sharing of gains. It is the overall package of incentives that should be considered by the AER.

Further, even where criteria governing the AER's discretion are introduced, appropriate measures should be put in place to maintain the transparency and predictability of the regulatory regime.[21] In this instance, the Businesses submit that the AER should be required to outline its proposed approach to any adjustment in its F&A Paper, and should be required to calculate any adjustment in accordance with the approach set out in the F&A Paper, unless there are circumstances that were unforeseen at the time the AER published the F&A Paper which justify a departure from the approach set out in the Paper. In the absence of the Businesses' proposed amendments to the AER Draft Rules, the AER's proposed changes would not promote the NEO and would be inconsistent with the RPPs.

The Businesses' detailed response to this Rule change proposal is set out in section A.7 of Annexure A to this Response.

4 DETERMINATION OF RATE OF RETURN

This section summarises the Businesses' response to the AER and EURCC Rule Change Proposals in respect of the capex and opex framework. Annexure B provides the Businesses' detailed comments and evidence in support of the Businesses' response to this aspect of the Proposals.

[19] 2006 TNSP Rule Determination, pxx.

[20] Clauses 6.5.8(a), 6.6.2(a) and 6.6.3(a) of the Rules.

[21] The AER recognised the need for such measures in its Rule Change Proposal (p61).

4.1 STATUS OF WACC REVIEWS IN DETERMINATIONS

AER Rule Change Proposal

The AER proposes the establishment of a single, common WACC review process for electricity transmission and distribution and the associated establishment by that review of a single, common set of WACC values, methodologies and credit rating levels. It further proposes that this single, common WACC review process should take the form currently reflected in Chapter 6A of the Rules, pursuant to which WACC review outcomes must be applied with the AER having no discretion to depart from a value, method or level adopted by it in a WACC review in making a transmission determination. The AER seeks to remove the (limited) scope currently existing under Chapter 6 of the Rules to revisit WACC review outcomes in the making of a distribution determination.

Businesses' Response

The Businesses agree, in principle, with the establishment of a single, common WACC review process for electricity transmission and distribution and the associated establishment by that review of a single, common set of WACC values, methodologies and credit rating levels. The Businesses further acknowledge that there is no readily apparent justification for the difference in the WACC determination frameworks as between Chapters 6 and 6A in relation to the application of WACC review outcomes in individual determinations.

To the extent that the alignment of the provisions of Chapters 6 and 6A with respect to the application of WACC review outcomes in making individual determinations is considered a necessary element of convergence, however, the Businesses do not agree that the provisions of Chapter 6A should be the basis for that convergence. Rather, any convergence should be based on Chapter 6 of the Rules. This is because:

- Contrary to the AER's assertions, the requirement under Chapter 6 of the Rules for persuasive evidence justifying a departure from the SORI has been highly effective in minimising debate in distribution determination processes on the application of SORI outcomes and in minimising Tribunal reviews of those determinations in respect of those elements of WACC estimation that were the subject of the SORI.[22]

- The (limited) scope to revisit WACC review outcomes in making determinations provided by Chapter 6 is critical to:

[22] In the AER decision making processes for those distribution determinations to which the 2009 SORI was applicable, the departures from the 2009 SORI outcomes ultimately proposed by the relevant DNSPs were confined to the value of gamma: ETSA Initial Regulatory Proposal, pp241-245; ETSA Revised Regulatory Proposal, pp190-195; CitiPower Initial Regulatory Proposal, pp304-307; CitiPower Revised Regulatory Proposal, pp355-369; Powercor Australia Initial Regulatory Proposal, pp312-315; Powercor Australia Revised Regulatory Proposal, pp346-360; SPI Initial Regulatory Proposal, pp298-302; SPI Revised Regulatory Proposal, pp323-340; JEN Initial Regulatory Proposal, pp175-179; JEN Revised Regulatory Proposal, pp242-268; United Energy Initial Regulatory Proposal, pp150-157, United Energy Revised Regulatory Proposal, pp196-212. While certain of these DNSPs also initially proposed departures from the 2009 SORI in respect of either the MRP or the risk free rate, these departures were not ultimately pressed by any of the DNSPs before the AER. As a consequence, the Tribunal reviews of AER decisions in distribution determinations on elements of WACC estimation that were the subject of the 2009 SORI have been wholly confined to the estimation of gamma: South Australian and Queensland DNSPs Review (ACT Nos 2 to 4 of 2010); Victorian DNSPs Review (ACT Nos 6 to 10 of 2010).

- providing required flexibility for the rate of return to reflect changes in market conditions, such as the GFC, and the associated data or information issues that may arise in individual determination processes;[23] and

- delivering accountability in, and an avenue for scrutiny and oversight of, AER decision-making on WACC, through the availability of merits review by the Tribunal.[24]

- These reasons for adopting Chapter 6 as the basis for any convergence are entirely consistent with the MCE's rationale for providing limited flexibility to revisit WACC review outcomes in making distribution determinations at the time of introducing Chapter 6. Developments subsequent to the MCE's decision only serve to underline the need for that flexibility.

By contrast the AER's asserted deficiencies in the Chapter 6 framework for WACC determination are unfounded and do not withstand scrutiny. Specifically:

- The AER's assertion that the discretion to depart from WACC review outcomes in making determinations is unnecessary cannot be reconciled with the sensitivity of the MRP and

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[23] The risk free rate, DRP and MRP are sensitive to market conditions: *Application by EnergyAustralia and Others* [2009] ACompT 8, [89]-[90]; 2009 SORI Decision, pp235, 237-238; AER Rule Change Proposal, pp78-79. The AER's own approach to estimation of the MRP at the time of the GFC and subsequently discloses the need for greater flexibility to reflect changes in market conditions than is provided by WACC reviews at approximately five yearly intervals: compare the AER's determination of the MRP in 2009 SORI Decision, pp237-238 to its determination of the MRP in AER, *Final decision Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011-30 June 2016* dated June 2011, pp50-53 and Appendix A, pp197-198, and AER, *Final decision Envestra Ltd Access arrangement proposal for the Qld gas network 1 July 2011-30 June 2016* dated June 2011, pp45-48 and Appendix A, pp185-186. Compare also the AER's determination of the MRP in Tasmanian Distribution Determination Draft Decision, pp27-8 to Queensland Transmission Determination Draft Decision, p33. While estimation of the DRP is not currently the subject of WACC reviews occurring under Chapters 6 and 6A, the AER's experience in respect of the DRP at the time of the GFC and subsequently also demonstrates the need for greater flexibility to reflect changes in market conditions than is provided by five yearly WACC reviews: AER Rule Change Proposal, pp78-81.

[24] An examination of the Tribunal's reviews of WACC decision making to date demonstrates that the availability of merits review has been essential to the robust and reliable estimation of WACC and investor confidence in WACC estimation: Tribunal finding of error in New South Wales DNSPs Review (*Application by EnergyAustralia and Others* [2009] ACompT 8, [91]-[92], [107], [116], [117], [125], [127]); Tribunal findings of error in South Australian and Queensland DNSPs Review (*Application by Energex Limited (No 2)* [2010] ACompT 7, [52], [87], [89], [145]; *Application by Energex Limited (Distribution Ratio (Gamma)) (No 3)* [2010] ACompT 9, [4]; *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9, [37], [42]); Tribunal finding of error in ACT gas distribution network service provider review brought by ActewAGL Distribution (ACT File No 1 of 2010) (*Application by ActewAGL Distribution* [2010] ACompT 4, [80]); Tribunal finding of error in New South Wales gas distribution network service provider review brought by JGN (ACT File No 5 of 2010) (*Application by Jemena Gas Networks (NSW) Ltd (No 5)* [2011] ACompT 10, [13], [86], [91]-[92]); AER concessions of error in Victorian DNSPs Review (*Joint Submissions of the Australian Energy Regulator and the Applicants in relation to Gamma* filed in the Tribunal in ACT File Nos 6 to 10 of 2010 on 11 July 2011; *The Australian Energy Regulator's Outline of Submissions concerning Debt Risk Premium: "Annualisation Error"* filed in the Tribunal in ACT File Nos 6 to 9 of 2010 on 18 March 2011).

risk free rate to changes in market conditions, as evidenced by recent experience of WACC estimation during and subsequent to the GFC.[25]

- Whereas the AER characterises distribution determination processes as involving the continual re-agitation by DNSPs on the basis of repeated and repackaged data and theory, and resultant reassessment by the AER, of WACC issues at each distribution determination, the experience in distribution determination processes to date discloses that DNSPs' submissions have been limited to the value and estimation of gamma which has been subsequently conceded by the AER and found by the Tribunal to be in error or parameters that are sensitive to changing market conditions, such as the MRP.[26]

- The AER's contention that the requirement for persuasive evidence for any departure from WACC review outcomes in making a distribution determination has not been effective is contradicted by the fact that:[27]

    - in those distribution determination processes to which the 2009 SORI applied, the departures from that SORI ultimately proposed by the relevant DNSPs have been confined to the value and estimation of gamma; and

    - the Tribunal reviews of AER decisions in distribution determinations on elements of WACC estimation that were the subject of the 2009 SORI have been wholly confined to the estimation of gamma.

- Finally, the AER's assertion that Tribunal reviews of WACC decisions under Chapter 6 have involved the pursuit of a 'spurious' level of precision in WACC parameter estimation cannot be reconciled with the fact that:[28]

    - the Tribunal has found error by the AER in estimating WACC in all reviews of WACC decisions brought to date;

    - the AER has itself conceded error in its estimation of WACC on a number of occasions, most notably in relation to its estimation of a value of gamma of 0.65 in the 2009 SORI; and

    - the quantum of the divergence between the gamma value determined by the AER in the 2009 SORI, of 0.65, and that determined appropriate by the Tribunal, of 0.25, suggests that the level of precision sought in Tribunal reviews is anything but 'spurious'.

4.2 ROLE OF 'PERSUASIVE EVIDENCE' IN WACC REVIEWS

AER Rule Change Proposal

The AER proposes to amend Chapters 6 and 6A of the Rules to remove the requirement for the AER, in undertaking a WACC review, to have regard to the need for persuasive evidence before

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[25] See footnote 23 above.

[26] See footnote 22 above.

[27] See footnote 22 above.

[28] See footnote 24 above.

adopting a credit rating level, or value attributable to or method of calculating a parameter value that departs from that previously adopted. The AER refers to this requirement in its Rule Change Proposal as the 'persuasive evidence test' or 'persuasive evidence threshold'. The AER proposes, in its place, a new requirement for the AER, in undertaking a WACC review, to have regard to the previously adopted values attributable to, or method of calculation, parameters that are the subject of that review.

Businesses' Response

The Businesses consider that the persuasive evidence requirement is important because:

- for at least some WACC parameters (for example gamma, equity beta and the debt to equity ratio), their value is relatively stable and slow to change;
- certainty and predictability in the return NSPs can expect to earn on their investments is important for the creation of incentives for, and the promotion of, efficient investment and, thus, the achievement of the NEO; and
- the persuasive evidence requirement delivers certainty and predictability in this rate of return by prescribing a minimum evidentiary standard for any departure from the value of those parameters that are relatively stable and slow to change and for any departure from the method of estimation of those WACC parameter values that are sensitive to changing market conditions, such as the risk free rate and MRP.

The Businesses observe, however, that referring to the existing Rule requirement, in undertaking a WACC review, to have regard to the need for persuasive evidence before adopting a credit rating level, or value or method for a parameter, that departs from that previously adopted as a 'persuasive evidence test' or 'persuasive evidence threshold' obscures the true nature of that requirement. The existing Rule requirement is one to 'have regard to' the need for persuasive evidence. The AER has an obligation, in undertaking a WACC review, to take into account the need for persuasive evidence and give that need weight as a fundamental element in decision-making.[29] The existing Rules do not establish persuasive evidence as a threshold requirement or statutory test for a departure by the AER from a previous level, value or method in a WACC review.

The Businesses consider that, given the importance of having a robust evidentiary basis before departing from a previously adopted value or method, or credit rating level in a WACC review, the persuasive evidence requirement applicable to WACC reviews should be in the nature of a 'test' or 'threshold', as the existing requirement is assumed to be in the AER Rule Change Proposal. Accordingly, the Businesses propose that, rather than amending the Rules to remove the existing persuasive evidence requirement applicable to WACC reviews, the AEMC should amend the Rules to require that the AER not adopt a credit rating level, or a value for, or method of calculating, a parameter that differs from that previously adopted unless there is persuasive evidence justifying that departure.

In proposing the removal of such a 'test' or 'threshold' requirement for persuasive evidence in WACC reviews, the AER:

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[29] The phrase 'have regard to' has been consistently interpreted to mean that the decision-maker must take into account, and give genuine consideration, to the matter to which regard is to be had and give it weight as a fundamental element in making the decision: *R v Hunt; Ex parte Sean Investments Pty Ltd* (1979) 180 CLR 322 at 329; *R v Toohey; Ex parte Meneling Station Pty Ltd* (1982) 158 CLR 327 at 333.

- contends that there is uncertainty over the proper interpretation and application of this persuasive evidence requirement; and

- asserts that such a persuasive evidence requirement operates to 'restrict the AER's ability to determine an efficient benchmark rate of return'.

The Businesses contend that the AER overstates the uncertainty over the interpretation and application of the persuasive evidence requirement. If, however, contrary to the Businesses' submissions, the AEMC forms the view that the persuasive evidence requirement is of uncertain meaning and effect, the Businesses submit that the Rule requirement for persuasive evidence should be reformulated to address any ambiguity, rather than removed and replaced with the AER's proposed requirement to have regard to previously adopted values or methodologies, or credit rating levels. This is because the AER's proposed requirement will not ensure due regard by the AER, in undertaking WACC reviews, to considerations of historical consistency and regulatory certainty.

The Businesses note, however, the AER's concern that a requirement for persuasive evidence before departing from a previously adopted credit rating level, or value for, or method of calculating, a parameter in a WACC review may operate to 'restrict the AER's ability to determine an efficient benchmark rate of return'. Rather than removing any requirement for persuasive evidence in WACC reviews from the Rules, however, the Businesses contend that this concern should be addressed by an amendment to the Rule provisions governing the application of WACC review outcomes in distribution determinations.

The Businesses observe that, as the parameter values for the risk free rate and DRP are determined only in making individual distribution determinations, any consideration of the overall rate of return can only occur in the making of a distribution determination and not before. The Businesses propose, therefore, that:

- the AER be required to determine on an overall rate of return to apply in a distribution determination that reflects the return required by investors in a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the DNSP; and

- to the extent of any inconsistency, this requirement prevail over the existing Rule requirement for persuasive evidence justifying a departure in that determination from a value, method or credit rating level set in an applicable WACC review.

The Businesses' detailed response to this Rule change proposal is set out in section B.2 of Annexure B to this Response.

4.3 TIMING OF WACC REVIEWS

AER Rule Change Proposal

The AER is concerned that the current Rules may give rise to 'inconsistency with respect to the timing of reviews that apply for TNSPs and DNSPs'.[30] So, for example, if the AER considered it necessary to initiate a WACC review under Chapter 6 *within* a five year interval, the obligation to conduct the WACC review under Chapter 6A *at* the five year interval would result in 'the AER inappropriately delaying its review under chapter 6, or duplicating its efforts (and potentially the

[30] AER Rule Change Proposal, p75.

efforts of other stakeholders) within a short period of time'.[31] Accordingly, the AER proposed Rule changes amend Chapters 6 and 6A of the Rules to provide that a WACC review is to be conducted by 1 March 2014 with further reviews to follow at intervals not exceeding five years.[32]

Businesses' Response

The Businesses agree with the alignment of the timeframe for WACC reviews under Chapters 6 and 6A of the Rules for the reasons discussed in section 4.1 above. Further, the Businesses do not object to achieving this alignment by providing for WACC reviews under Chapters 6 and 6A to be conducted at intervals less than five years but observe that the potential detrimental effect of this on regulatory certainty would be ameliorated by enshrining criteria in the Rules for the exercise of the AER's discretion to conduct such an earlier WACC review. This, in turn, would better promote efficient investment and, thus, better contribute to the achievement of the NEO and the RPPs, than the AER's proposed Rule changes.

The Businesses' detailed response to this Rule change proposal is set out in section B.3 of Annexure B to this Response.

4.4 DEFINITION OF RETURN ON DEBT

AER and EURCC Rule Change Proposals

In the AER Rule Change Proposal, the AER asserts that the existing Rules' definition of the DRP is problematic for three reasons as follows:

- First, while the Rules' definition of the rate of return implies that the cost of debt should reflect that of 'a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the [network] business of the provider'[33], the yield on 'observed annualised Australian benchmark corporate bond[s]' with a particular credit rating and maturity may not fully reflect the risks of this benchmark provider.[34]

- Secondly, the AER contends that the existing Rules' definition of the DRP means the AER lacks the required flexibility to adapt estimation practices to changes in debt markets and resultant changes in benchmark financing structures. The AER notes, in particular, the data paucity issues that have plagued the estimation of the DRP in accordance with the Rules' definition during and subsequent to the GFC and the resultant debate regarding DRP estimation.[35]

- Thirdly, the AER contends that, as a consequence of the above, the benchmark DRP set by the AER in recent determinations has been significantly above NSPs' actual costs of debt.[36]

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[31] AER Rule Change Proposal, p75.

[32] AER Draft Rules, pp20, 81 (proposed clauses 6.5.4(b), 6A.6.2(d)).

[33] Clauses 6.5.2(b), 6A.6.2(b) of the Rules.

[34] AER Rule Change Proposal, p77.

[35] AER Rule Change Proposal, pp78-79.

[36] AER Rule Change Proposal, pp79-80.

For these reasons, the AER proposes Rule changes to remove the existing Rules' definition of the DRP[37] and provide for the DRP to form the subject of WACC reviews[38]. The AER proposes that its proposed SOCC will set out the definition and methodology for estimation of the DRP, as well as the risk free rate, and thus prescribe that definition and methodology for the purposes of transmission and distribution determinations to which that SOCC is applicable.[39]

Like the AER, in the EURCC Rule Change Proposal, the EURCC contends that, under the current Rules, the return on debt allowed in recent AER determinations has significantly exceeded regulated NSPs' actual costs of debt, delivering excessive profits to NSPs.[40] The EURCC further contends that this has created incentives for inefficient over-investment by NSPs.[41]

The EURCC maintains that these outcomes under the current Rules are a consequence of the two problems with the existing Rules' definition of the DRP as follows:

- First, the DRP definition specifies the 'wrong' benchmark in that this benchmark:[42]
    - is plagued by the data paucity issues also identified by the AER; and
    - requires the measurement of the DRP and risk free rate over a short averaging period despite the fact that both of these elements of the cost of debt vary significantly over short periods.
- Secondly, the DRP definition precludes the AER from having regard to the actual cost of debt in determining the return on debt.[43]

In contrast to the AER, the EURCC considers that the methodology for estimation of the return on debt should be specified in the Rules and not left to the exercise of the AER's regulatory discretion in a WACC review.[44] The EURCC proposes that the Rules be amended to specify that the return on debt be estimated using:[45]

- 5 year rather than 10 year maturity debt, so as to reflect current NSP practice;
- all broad BBB and A rated corporate debt issued in Australia, so as to ensure a more liquid market of bonds to establish the benchmark; and

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[37] AER Draft Rules, pp20, 81.

[38] AER Draft Rules, pp20-21, (proposed clauses 6.5.4(d), 6A.6.2(f)).

[39] AER Rule Change Proposal, p81.

[40] EURCC Rule Change Proposal, pp20-22.

[41] EURCC Rule Change Proposal, pp22-23.

[42] EURCC Rule Change Proposal, pp24-27.

[43] EURCC Rule Change Proposal, pp27-28.

[44] EURCC Rule Change Proposal, pp45-48.

[45] EURCC Rule Change Proposal, pp42-43.

- a five year rolling mechanism pursuant to which the cost of debt is mechanistically updated in each regulatory year of the regulatory control period by reference to the historical average yield to maturity for broad BBB and A rated corporate bonds issued in Australia in the five year period ending on 31 December of the previous year.

In addition to proposing Rule changes that define the cost of debt so as to give effect to this proposal[46], the EURCC also proposes amendments to:[47]

- remove the maturity and credit rating levels used in estimating the cost of debt from the scope of WACC reviews; and

- remove from the considerations to which the AER must have regard in conducting WACC reviews those considerations providing for a forward-looking rate of return commensurate with prevailing conditions in the market for funds and a return on debt that reflects current borrowing costs, as these considerations are inconsistent with the backward-looking approach to the estimation of the return on debt proposed by the EURCC.

Businesses' Response

The Businesses do not agree with the AER's and EURCC's contention that the divergence between NSPs' actual cost of debt and the return on debt allowed by the AER in recent determinations represents a problem with the existing Rules' definition of the DRP.

To assist in the Businesses' consideration of the AER and EURCC proposals concerning the cost of debt, the Businesses requested that CEG review the analysis undertaken by the AER and the EURCC on the gap between the actual and benchmark DRP and comment on any actual or implied implications of this for the reasonableness of the rates of return allowed by the AER under the current Rules. The resultant CEG DRP Rule Change Report is attached to this Response as Attachment 77. CEG's findings can be summarised as follows:

- The key finding of the CEG DRP Rule Change Report is that the AER has misinterpreted the data on actual debt issues and that, when properly interpreted, this data supports the view that the overall rate of return in AER determinations has been underestimated, not that it has been overestimated.

- The AER's approach is to compare the actual cost of recent debt issued by businesses with the (higher) allowed cost of debt and, on this basis, conclude that the regulatory allowance has been overestimated. However, in doing so, the AER fails to take into account that:

    - the lower DRP on actual debt can be fully explained by the fact that the average maturity of that debt was less than 10 years (5.5 years excluding debt issued by SPI) ; and

    - while issuing short term debt reduces interest costs, there is an offsetting increase in the cost of equity.

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[46] EURCC Rule Change Proposal, pp50-51 (proposed clauses 6.5.2(b), 6.5.2(e)).

[47] EURCC Rule Change Proposal, pp52-53 (proposed deletion of clauses 6.5.4(d)(4), 6.5.4(d)(6), 6.5.4(e)(1)-(3)).

- A second factor is the outcome of the well accepted Modigliani Miller theorem. This theorem states that firm specific risk is constant and that all financing strategies can do is shift this risk around to different investors. As a result, any debt strategy that reduces interest rates must also reduce the amount of risk passed onto debt holders (otherwise they would not accept lower interest rates). Consequently, the debt cost savings from issuing more short term debt are fully offset by a higher cost of equity – leaving the overall WACC unchanged.

- The equity beta under the Rules has been based on observations of businesses that, on average, issue 10 year debt. That is, the cost of equity and debt under the Rules are determined on a consistent basis in terms of the underlying term of the debt financing.

- The AER's analysis in its Rule change proposal breaks this internal consistency. It takes the observed lower cost of debt on short term issues but ignores the consequential effect on the cost of equity. As a result, its conclusion that the overall return (WACC) has been set too high is based on a form of 'cherry-picking'.

The underestimation of the cost of equity is exacerbated by the AER's unwillingness to set an MRP that is consistent with market conditions and falling risk free rates.

The benchmark return on debt should reflect efficient NSP debt financing practices. This is required to contribute to the achievement of the NEO and the RPPs, as the efficiency objectives of the NEO may not be achieved if an NSP is not provided with a reasonable opportunity to recover at least its efficient costs.

Further, the Rules:

- expressly contemplate that the return on debt should be forward looking,[48] whereas actual debt costs at the time of a determination have both a forward looking and a backward looking element; and

- require the term to maturity of the risk free rate to also apply to the DRP but NSPs in practice typically face different term exposures on the risk free rate and DRP.

The Businesses agree with the AER and EURCC that the GFC has created difficulties in the measurement of the DRP under the Rules, thus resulting in debate before the AER and disputes before the Tribunal regarding DRP estimation, although the Businesses consider the constraints on the AER's flexibility to address data availability issues by reason of the Rules are overstated by the AER.

Finally, the Businesses consider that the current Rules are deficient in that they make no explicit provision for the recovery of other debt costs, such as early refinancing costs, hedging costs, underwriting fees, legal fees and issue credit rating fees, which would be a material cost for an efficient NSP.

Accordingly, the Businesses agree with the AER and EURCC that the existing Rule provisions governing the estimation of the return on debt should be amended.

[48] Clauses 6.5.4(e)(1), 6A.6.2(j)(1) of the Rules.

The AER proposal for unfettered discretion would expose NSPs to increased and unnecessary risk and uncertainty. For these reasons, the Businesses submit that the AER's proposed Rule changes should not be adopted by the AEMC.

While the EURCC's proposed backward looking benchmark approach to estimating the cost of debt may be appropriate for estimation of the element of the NSPs' debt costs that is backward looking (that is, the debt margin over swap rate), the proposed five-year term is based on a conceptual flaw and does not reflect efficient behaviour. Neither could the benchmark be achieved without materially compromising other benchmark WACC parameters.

For these reasons, the Businesses contend that the preferable Rule changes to solve the problems identified above in relation to the current Rule provisions governing estimation of the return on debt would define the cost of debt as the sum of:

- the forward looking fixed swap rate with a term equal to the length of the regulatory control period;
- the debt margin over swap, determined using a rolling backward looking benchmark approach, with a term equal to the benchmark maturity structure of an efficient DNSP; and
- other debt financing costs.

The Businesses consider, however, that significant consultation would be required to determine how such an approach would work and should be implemented in the Rules.

The Businesses' detailed response to this Rule change proposal is set out in section B.4 of Annexure B to this Response.

5 REGULATORY DECISION-MAKING PROCESS

This section summarises the Businesses' response to the AER Rule Change Proposal in respect of the regulatory decision-making process. Annexure C provides further detailed comments and evidence in support of the Businesses' response to this aspect of the Proposal.

5.1 SUBMISSIONS RECEIVED DURING A DETERMINATION PROCESS

AER Rule Change Proposal

The AER proposes to limit the scope for NSPs to make submissions in relation to their determinations following an AER invitation for written submissions during the regulatory review process. The AER is seeking to address its concerns that NSPs have used the submission process to put before the AER material that 'should have properly formed part of their regulatory or revenue proposals' and which make it difficult for other parties to properly consider the NSPs' proposals.

Businesses' Response

The Businesses reject the extent of the problem raised by the AER. The Businesses observe that NSPs have used the opportunity to make submissions in circumstances where it was not possible to include the material in their revised regulatory proposals, including where:

- information was not available at the time the NSP lodged its regulatory proposal; and

- the NSP was not in a position to obtain information from third party experts in sufficient time to include that material in its revised regulatory proposal (the Rules providing only 30 business days for the NSP to submit its revised regulatory proposal, and the AER typically allowing a longer period within which to make written submissions).

A DNSP's revised regulatory proposal is limited to only making revisions to incorporate the substance of any changes required to address matters raised in the draft determination. The AER's proposed Rule change is not likely to contribute to the achievement of the NEO and is inconsistent with the RPPs as NSPs would be deprived of the opportunity to inform the AER of issues relevant to the AER's determination. This is inconsistent with section 16 of the Law and the principle of procedural fairness, which would likely have the effect of invalidating any such Rules. The AER's proposed Rule changes would also mean that the AER is less likely to be in a position to make a full and thorough assessment and thus less likely to be in a position to:

- make a determination that promotes the efficient investment in, and efficient operation and use of, electricity services; and
- ensure that the NSP is provided with a reasonable opportunity to recover its efficient costs.

The risk of regulatory error would therefore be increased under the AER's proposed Rule change.

The Businesses submit that, to the extent the AEMC determines that a change to the Rules to facilitate greater consultation than is presently provided for is desirable, the Rules proposed by the AER should be amended to allow DNSPs to include with their revised regulatory proposals submissions to the AER:

- in response to stakeholder submissions on the initial regulatory proposal. This will be the first opportunity the DNSP has to make submissions on stakeholder submissions;
- in support of the initial regulatory proposal (including where that proposal is not revised);
- in response to any aspect of the AER's draft determination (whether or not the subject of a revision in the revised regulatory proposal); and
- regarding any changed circumstances or other developments that are not reflected in the initial regulatory proposal.

Further, given that 30 business days is an insufficient period of time for DNSPs to prepare all material in response to the AER's draft determination, the Businesses propose an amendment to extend the period of time available to DNSPs to prepare their revised regulatory proposals from 30 business days to 40 business days.

Finally, to ensure that all stakeholders have adequate opportunity to comment on each other stakeholder's submissions, the Businesses propose the introduction of new provisions to establish a 'cross-submission' process following the closing of interested party submissions on the draft determination and revised regulatory proposal, in which all stakeholders (including the DNSP the subject of the determination) are permitted to make submissions on issues raised in any other submissions to made to the AER.

The Businesses' detailed response to this Rule change proposal is set out in section C.1 of Annexure C to this Response.

5.2 LATE SUBMISSIONS AND REGULATORY PROPOSALS

AER Rule Change Proposal

The AER is proposing to remove the its discretion to consider any late submission made to the AER and to prohibit the AER from considering late submissions and late revised regulatory proposals.

The AER has not advanced any justification for removing the AER's discretion to have regard to late submissions or prohibiting the AER from taking late submissions and regulatory proposals into account.

Businesses' Response

The Businesses support the discretion that the AER has under the existing framework to take late submissions into account.

The AER's proposal may operate in a manner that is inconsistent with section 16 of the Law, as it is contrary to the requirement in that section to ensure that a regulated NSP is given a reasonable opportunity to make submissions in respect of a determination to apply to it before it is made. Further, the proposed amendments prohibiting the AER from taking into account late submissions would be inconsistent with section 28ZC of the Law, which provides that AER 'may, but need not' consider a late submission. By removing the AER's discretion to take into account late submissions, the AER's proposed Rule change is inconsistent with section 28ZC of the Law, and if enacted would likely be void by reason of that inconsistency.[49]

The Businesses submit that the AER's proposal is not likely to contribute the achievement of the NEO as it is contrary to sections 16 and 28ZC of the Law, and would increase the risk of the AER falling into regulatory error. The Businesses observe that, under the existing legislative framework, the AER has the power not to take into account material that is not provided to it in a timely fashion, where reasonable to do so and no change to the Rules is necessary.

The Businesses' detailed response to this Rule change proposal is set out in section C.2 of Annexure C to this Response.

5.3 USE OF CONFIDENTIAL INFORMATION

AER Rule Change Proposal

The AER proposes to introduce a new clause to explicitly provide that the AER may give such weight to confidential information identified in a regulatory proposal or revised regulatory proposal as it considers appropriate, having regard to the fact that such information has not been made publicly available.

Businesses' Response

The Businesses reject the extent of the problem characterised by the AER. The Businesses note that an overwhelming majority of the material in support of their proposals was made publicly available.

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[49] This is because Rules enacted by the AEMC are delegated legislation made and amended under the Law. Any Rule that were inconsistent with the Law would likely be invalid. For further discussion of the impact of inconsistency in delegated legislation see sections C.1 and C.2 of Annexure C to this Response.

In any event, the Businesses consider that the existing regime strikes the correct balance between preserving the confidentiality of sensitive information and ensuring transparency in decision-making. In particular, the Businesses consider that:

- the existing regime correctly draws a distinction between confidential information provided by the NSP the subject of the regulatory determination and confidential information provided by other stakeholders. The information submitted by the NSP the subject of the determination will necessarily be key information to the AER's determination of efficient expenditure forecasts. Giving the AER a discretion to accord reduced weight to confidential NSP information is undesirable as it would increase regulatory error by creating a risk that the AER would determine expenditure forecasts that do not adequately take confidential information into account, thereby curing efficient investment in the network and preventing the recovery of efficient costs;

- the AER's information gathering powers are such that it can have confidence in confidential information produced by NSPs, even where this information has not been made publicly available; and

- under the existing legislative framework, the AER has a range of powers it can rely on to disclose confidential information submitted by NSPs in order to test its veracity and allow for transparency of decision making. This includes, for example, the AER's power to disclose confidential information:

    - if any detriment caused by the disclosure of the information would be outweighed by the public benefit in disclosing the information;

    - with the written consent of the person who gave it the information or the confidentiality claimant;

    - to any person authorised to perform or exercise a function or power on behalf of the AER (including for instance the AER's expert advisers and third party consultants); and

    - if the information is disclosed in such a way as to conceal the identity of the person to whom the information relates.

The Businesses submit that the existing framework in the Law and Rules strikes the correct balance between confidentiality and transparency and no change to the Rules is necessary.

The Businesses' detailed response to this Rule change proposal is set out in section C.3 of Annexure C to this Response.

5.4 FRAMEWORK AND APPROACH PAPER

AER Rule Change Proposal

The AER proposes to change the status of its conclusions at the F&A Paper stage of the distribution determination process. The AER proposed amendments (among others) to:

- provide for the AER to apply a control mechanism that differs from the control mechanism set out in the F&A Paper if, in light of the DNSP's regulatory proposal and the submission received, the AER considers that there are circumstances which were unforeseen at the time which justify a departure; and

- remove the requirement for the AER to set out in the F&A Paper the application of each of the incentive schemes to the DNSP.

Businesses' Response

The Businesses agree that the AER should have some flexibility to revisit the formulaic expression of the control mechanism for each determination. Indeed, the Businesses consider that the AER already has the power under the existing Rules to make such amendments and note that the AER has itself amended the control mechanism formulas in past determinations.[50]

To the extent the AEMC considers that clarification of the AER's power to revisit the formulaic expression of the control mechanism is desirable, the Businesses submit that, in contrast to the AER's proposal, there needs to continue to be a 'locking in' of the type of control mechanism that will be applied in the determination prior to the lodging of the regulatory proposal. Given the significant flexibility provided for in the Rules as to the type of control mechanism that can be applied,[51] a failure to 'lock in' at the F&A Paper stage at least the type of control mechanism to be applied:

- creates an unacceptable degree of regulatory uncertainty for DNSPs. It was for this reason that the SCO opted to provide for the locking in of the control mechanism 19 months in advance of the distribution determination;[52]

- potentially imposes a prohibitive administrative burden on DNSPs, particularly given the temporal constraints in place after the regulatory proposals have been submitted; and

- may constrain the DNSPs' ability to properly assess any new proposed type of control mechanism. DNSPs need sufficient time to consider and reflect upon any new control mechanism to ensure any unintended and perverse outcomes that may result from the introduction of that mechanism are avoided, and to properly reflect on the impact that the type of the control mechanism has on other parts of their regulatory proposals. ESCOSA's implementation of a 'Q factor' to correct for forecast errors in total sales in South Australia demonstrates the implications that the control mechanism can have for other parts of a regulatory proposal (in that case, the required rate of return).[53]

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[50] Compare the form of control mechanism in Appendix D of the AER's *Final Framework and Approach Paper, ETSA Utilities, 2010-15,* November 2008 and the control mechanism in section 4.4 of the AER's South Australian Distribution Determination Final Decision (in particular, see the additional pass through term); compare the form of control mechanism in Appendix F of the AER's *Final framework and approach paper for Victorian electricity distribution regulation, Regulatory control period commencing 1 January 2011*, May 2009 and section 4.5.1 and Appendix E of the AER's Victorian Distribution Determinations Final Decision (in particular, see the additional pass through term, the definition of CPI and the licence fee factor definition). See also page 45 of the AER's South Australian Distribution Determination Draft Decision where the AER stated: 'the AER considers that the WAPC formula can be amended where this would reflect (or better reflect) the reasoning set out in the framework and approach').

[51] Clause 6.2.5(b) of the Rules.

[52] SCO, *Table 1: SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, 1 August 2007, pp44-45.

[53] ESCOSA, *2005-2010 Electricity Price Distribution Determination, Part A, Statement of Reasons*, April 2005, p142, section 12.8.1; ESCOSA, *2005-2010 Electricity Distribution Price Determination, An application by ETSA Utilities for a review pursuant to section 31 of the Essential Services Commission Act*

The Businesses also share the AER's desire to reduce inefficient consultation required by the Rules. The Businesses consider, however, that an amendment to the Rules to seek to remove the potential for inefficiencies arising in the future (rather than only those inefficiencies that have arisen historically) would further promote the NEO. The Businesses consider that requiring publication of the F&A Paper only in certain circumstances will further reduce the administrative burden of the Paper on the AER and DNSPs. In particular, the Businesses consider that an F&A Paper is required only where:

- no distribution determination applies to the service provider;
- the DNSP owns controls or operates dual function assets; or
- either the AER or the DNSP gives notice to the other (25 months before the end of the current regulatory control period) that it considers:
    - a control mechanism that differs in a material respect from the control mechanism in the distribution determination currently in force ought to apply;
    - classification of distribution services that differs in a material respect from the classification of in the distribution determination currently in force ought to apply; or
    - an adjustment for the use or forecast use of assets forming part of the RAB for the provision of services other than standard control services in the control mechanism or by an adjustment to the building blocks or a combination of these may be required.

The Businesses' detailed response to this Rule change proposal is set out in section C.4 of Annexure C to this Response.

5.5 CORRECTING FOR MATERIAL ERRORS

AER Rule Change Proposal

The AER proposes to remove the limitations on its ability to revoke a determination by reference to the character of error or deficiency and to introduce a power to revoke or amend a distribution determination where:

- the annual revenue requirement was set on the basis of information that was false or misleading in a material particular; or
- there was a material error or deficiency in the determination.

Businesses' Response

The Businesses reject the AER's proposed Rule changes on the basis they would significantly reduce regulatory certainty and eliminate finality in decision-making. The proposed changes reduce the incentives on regulated NSPs to take measures to reduce expenditure and the potential to deter efficient capex on networks and efficient increases in opex. The Businesses do not consider there to be any associated benefit with the change - while the Rules in their current form may lead to certain

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2002, Decision and reasons for decision, 31 May 2005, pp39-40. See also ESCOSA, *2005-2010 Electricity Distribution Price Determination, An application by ETSA Utilities for a review pursuant to section 31 of the Essential Services Commission Act 2002, Decision and reasons for decision,* 31 May 2005, pp63-65.

errors going uncorrected, the limitations on the AER's ability to correct for material errors are just as likely to operate to advantage and disadvantage the DNSP the subject of the determination. It is also not clear to the Businesses why the AER requires a power to 'amend' distribution determinations, rather than relying on its power to revoke.

The Businesses consider that the existing Rules, with clearly specified and limited scope to revoke distribution determinations, provide greater regulatory certainty and thus promote the NEO and are consistent with the RPPs.

The Businesses' detailed response to this Rule change proposal is set out in section C.5 of Annexure C to this Response.

5.6 TIMEFRAME FOR THE CONDUCT OF WACC REVIEW

AER Rule Change Proposal

The AER proposes to amend the distribution consultation procedures as they apply to the WACC review process, proposing to allow 100 business days for the review rather than 80 business days.

Businesses' Response

The Businesses agree that a consultation period of longer than 80 business days is required in order to reduce the scope for regulatory error when the AER undertakes a review of the WACC. However, the additional time should not be solely reserved for the AER.

An extended timeframe for the WACC review, where this involves an increase to both the timeframe for the making of stakeholder submissions and the making of the AER's final decision, would promote the NEO and is consistent with the RPPs as it facilitates a thorough analysis of the materials is more likely to ensure the NSPs recover their efficient costs of capital.

The Businesses also observe that, historically, NSPs' ability to respond to the AER's proposed WACC has been compromised by the consultation occurring over the Christmas and New Year period, during which time it is difficult to secure the necessary resources, including the assistance of third party experts.

The Businesses therefore propose that in conjunction with increasing the total time for the making of the AER's final decision after its proposal is released, the Rules be amended to:

- increase the total time for the making of stakeholder submissions from 30 business days to 45 business days; and
- for the purposes of calculating the minimum time for the making of written submissions and the time for the making of a final decision, exclude from the definition of 'business days' the period from 25 December to 14 January.

The Businesses' detailed response to this Rule change proposal is set out in section C.6 of Annexure C to this Response.

5.7 TIMEFRAME FOR ASSESSMENT OF PASS THROUGH EVENTS, CONTINGENT PROJECTS AND CAPEX REOPENERS

AER Rule Change Proposal

The AER is seeking to address its concerns with the short length and binding nature of the timeframes within which it is required to make a decisions on applications for cost pass through, contingent projects and capex reopeners.

The AER has accordingly proposed amendments to the Rules to change the timeframe for the making of its decisions to 40 business days, and to give the AER a power to extend this timeframe by up to an additional 60 business days if the application involves questions of unusual complexity or difficulty or the AER requires further information.

Businesses' Response

As noted in section 3.3 above, the Businesses oppose the AER's proposed amendments to introduce capex reopeners and contingent projects into the distribution regulatory framework in Chapter 6 of the Rules. The Businesses consider that pass through applications will, in most instances, be complex and be closely linked with administrative processes (such as government inquiries), and thus will almost always take longer than 40 business days to consider and consult on. However, the AER's proposal continues to provide a binding timeframe that cannot be extended in any circumstances. The Businesses consider that, as a result, the AER's proposed approach may prevent the AER from determining efficient levels of investment and efficient costs associated with operating the network.

Further, the Businesses consider that the AER can be afforded the flexibility required to consider complex pass through applications by the introduction of a 'stop-the-clock' mechanism whereby the AER has the power to exclude from the calculation of the timeframe for the making of the decision those periods during which it has requested and is awaiting information from third parties or the DNSP that submitted the application or where an administrative process which is likely to impact on the assessment or quantification of the effect of the relevant pass through event is being conducted.

The Businesses' detailed response to this Rule change proposal is set out in section C.7 of Annexure C to this Response.

6 TRANSITIONAL ARRANGEMENTS

AER Rule Change Proposal

As noted in section 3.3 above, the AER proposed changes to the Rules that would fundamentally change the approach to the roll forward of the RAB, and thereby change the incentives facing NSPs to incur capex and invest in the network.

The AER observed that '[c]hanges to the incentive framework can only influence future investment decisions, not past ones' and indicated that it recognised the importance of not changing the 'rules of the game' once the regulatory control period has commenced in order to promote investor certainty.[54]

The AER therefore proposed transitional provisions to extend the existing Rule provisions regarding the RAB roll forward to the next regulatory control period for each NSP.[55] This means that its

[54] AER Rule Change Proposal, pp108-109.

proposed amendments to the RAB roll forward provisions would only take effect in the regulatory control period after the next regulatory control period for each NSP.

Businesses' Response

The Businesses agree that, to the extent the AEMC is minded to make the AER's proposed changes regarding the roll forward of the RAB, the changes should not come into effect in the next regulatory control period. To do so would be contrary to good regulatory practice, would increase regulatory uncertainty and have consequences for investment in the networks going forward, contrary to the NEO and the RPPs.

Given this, to the extent the AEMC decides to change the RAB roll forward provisions going forward, it would promote the NEO and the RPPs to provide for the changes to take effect only in respect of the regulatory control period after the next regulatory control period for each NSP.

[55] AER Draft Rules, p151 (proposed clause 11.43.3).

ANNEXURE A - CAPEX AND OPEX FRAMEWORK

A.1 SETTING ESTIMATES OF REQUIRED EXPENDITURE AND CONSEQUENTIAL AMENDMENTS TO PROCESS MATTERS

AER Rule Change Proposal

Current Rule provisions

Both Chapters 6 and 6A provide that the AER must accept the NSP's forecast of required opex or capex in its building block or revenue proposal if the AER is satisfied that the total of the forecast opex or capex respectively for the regulatory control period reasonably reflects:[56]

- the efficient costs of achieving the opex or capex objectives respectively;
- the costs that a prudent operator in the circumstances of the relevant NSP would require to achieve those objectives; and
- a realistic expectation of the demand forecast and cost inputs required to achieve those objectives.

If the AER is not so satisfied, the AER must not accept the NSP's forecast of required opex or capex (as the case may be) included in the NSP's building block or revenue proposal.[57] In this instance, the AER must estimate the total of the NSP's required opex or capex that the AER is satisfied reasonably reflects the opex or capex criteria respectively taking into account the opex or capex factors.[58]

Under Chapter 6, if the AER refuses to approve the DNSP's forecast of required opex or capex, the substitute amount estimated by the AER must be determined on the basis of the current regulatory proposal and amended from that basis only to the extent necessary to enable it to be approved in accordance with the Rules.[59] By contrast, under Chapter 6A, if the AER refuses to approve the TNSP's forecast of required opex or capex for the reason that the AER is not satisfied that that forecast reasonably reflects the opex or capex criteria respectively, taking into account the opex or capex factors respectively, the AER is not subject to such a constraint. It is for the AER to determine the forecast opex or capex for each regulatory year (and the total forecast opex or capex for the regulatory control period) which it is satisfied reasonably reflects the opex or capex criteria, taking into account the opex or capex factors.[60]

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[56] Clauses 6.5.6(c), 6.5.7(c), 6A.6.6(c), 6A.6.7(c) of the Rules.

[57] Clauses 6.5.6(d), 6.5.7(d), 6A.6.6(d), 6A.6.7(d) of the Rules.

[58] Clauses 6.12.1(3)(ii), 6.12.1(4)(ii), 6A.14.1(3)(ii), 6A.14.1(4)(ii) of the Rules.

[59] Clause 6.12.3(f) of the Rules.

[60] Clauses 6A.13.2(b) of the Rules.

AER's characterisation of 'the problem'

The AER observes that 'a significant proportion of the more recent rises [in electricity prices] can be attributed to increases in regulated network charges',[61] this trend is expected to continue[62] and that the replacement of ageing assets, increased peak demand, growing customer connections, higher reliability standards and expected increases in labour and material costs 'do not fully account for the level of observed increases'.[63] The AER also seeks to demonstrate that opex and capex forecasts, and resultant allowed revenues, accepted in the AER's transmission and distribution determinations to date have represented significant increases on actual expenditure in the previous regulatory periods.[64]

Against this background, the AER contends that the existing framework for setting forecasts of capex and opex delivers 'systematically inflated expenditure forecasts'.[65] The AER asserts that, because the framework requires the AER to accept an NSP's expenditure forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure, the framework results in expenditure forecasts that are upwardly biased, selected by the NSP from the upper end of 'the "reasonable" range', and precludes the AER from amending forecasts proposed by NSPs where there are lower forecasts within that range.[66]

The AER asserts that this problem is exacerbated for distribution because, under Chapter 6 of the Rules, if it rejects an NSP's expenditure forecasts, the AER may amend the NSP's expenditure forecasts 'only to the extent necessary' to enable them to be approved in accordance with the Rules. As a consequence, the AER says, it can only amend the NSP's expenditure forecasts to the minimum extent necessary to bring the forecasts within the 'reasonable' range, with the consequence that the forecast determined by the AER is necessarily at the top of that range.[67]

The AER further asserts that, as it is also required under Chapter 6 to determine substitute forecasts 'on the basis of' the NSP's current regulatory proposal, it must determine those substitute forecasts 'in the same manner as determined by the DNSP in their proposal', which, in turn, generally requires the AER to undertake a 'line by line assessment' of the NSP's 'bottom up' calculation of its forecasts.[68] This, in turn, is said to:

- prevent the AER from weighing up all available information, data and evidence, including for example top down benchmarking, bottom up modelling, activity based analysis, a

[61] AER Rule Change Proposal, p5.

[62] AER Rule Change Proposal, p6.

[63] AER Rule Change Proposal, p6.

[64] AER Rule Change Proposal, pp7-10.

[65] AER Rule Change Proposal, p28. See also pp12, 19.

[66] AER Rule Change Proposal, p13. See also pp25, 27-28.

[67] AER Rule Change Proposal, pp13, 25-26, 28-29.

[68] AER Rule Change Proposal, pp13, 26, 29.

detailed review of a sample of projects and/or an expert review of costs, and determining on an 'impartial' forecast;[69]

- impose a high evidentiary burden on the AER not envisaged at the time of introduction of the AEMC's 2006 TNSP Rule Determination;[70] and

- result in an assessment process which is inconsistent with the current incentive framework, pursuant to which NSPs are to efficiently prioritise expenditure based on changing priorities and circumstances in order to meet required service levels.[71]

The AER concludes that '[w]hile it is difficult to quantify the extent to which price rises have exceeded efficient levels, inflated forecasts have been a factor in the price rises faced by consumers'.[72]

AER's proposed Rule changes

The AER Rule Change Proposal proposes:

- The removal of the existing requirements in Chapters 6 and 6A of the Rules for the AER to:[73]

    - accept a NSP's forecast of required opex or capex if the AER is satisfied that the total of the forecast for the regulatory control period reasonably reflects the opex or capex criteria, respectively, namely the efficient costs of achieving the opex or capex objectives, the costs that a prudent NSP in the circumstances of the relevant NSP would require to achieve those objectives and a realistic expectation of the demand forecast and cost inputs required to achieve those objectives;

    - if the AER is not so satisfied, not accept the NSP's forecast of required opex or capex; and

    - approve or refuse to approve the TNSP's total revenue cap for the regulatory control period and maximum allowed revenue for each year of that period or the DNSP's annual revenue requirement for each year of the regulatory control period (as the case may be), set out in the relevant NSP's current proposal.

- The replacement of those requirements with a new requirement for the AER to determine the total of the forecast of required opex or capex of the NSP for the regulatory control period, and the forecast of required opex or capex for each year of that period, that 'the

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[69] AER Rule Change Proposal, pp 13, 26, 29.

[70] AER Rule Change Proposal, p29.

[71] AER Rule Change Proposal, pp30, 31-32.

[72] AER Rule Change Proposal, p14.

[73] Clauses 6.5.6(c)-(d), 6.5.7(c)-(d), 6.12.1(2)-(4), 6A.6.6(c), 6A.6.6(d), 6A.6.7(c)-(d), 6A.14.1(1)-(3) of the Rules and Chapter 10 definitions of 'operating expenditure criteria' and 'capital expenditure criteria'; AER Draft Rules, pp23, 25, 48-49, 88, 91, 116-117, 144-145.

AER considers would meet the efficient costs that a prudent [NSP] would require to achieve' the opex or capex objectives.[74]

The AER concedes this proposal may be characterised as the replacement of the 'propose-respond' model in the existing Rules with a 'consider-decide' model.[75] However, it asserts that '[i]n practice, the regulatory process will still begin with a proposal from the NSP, which the AER will use as a base'[76] and that its 'changes do not fundamentally alter the conduct of a regulatory reset process'[77].

In addition, the AER proposes the deletion of the existing provisions of Chapter 6 of the Rules that require the AER to:

- approve the total revenue requirement for the regulatory control period and annual revenue requirement for each year of the period set out in a DNSP's current regulatory proposal if the AER is satisfied those amounts have been properly calculated using the post-tax revenue model on the basis of amounts calculated, determined or forecast in accordance with the requirements of Chapter 6;[78] and
- if the AER refuses to determine an amount or value, determine the substitute amount or value on the basis of the DNSP's current regulatory proposal and amend it from that basis only to the extent necessary to enable it to be approved in accordance with the Rules.[79]

Businesses' Response

Requirements to accept an NSP's expenditure forecast if it 'reasonably reflects' opex or capex criteria and determine substitute forecasts that amend a DNSP's forecasts 'only to the extent necessary'

The Businesses disagree with the AER's characterisation of its Rule change proposal as one that does not fundamentally alter the regulatory process. The AER's proposed Rule changes remove all those existing requirements and limitations that establish the 'propose-respond' model that is a fundamental tenet of the existing expenditure forecasting framework under the Rules. The AER would no longer be required to start with the NSP's proposal in setting expenditure forecasts if the AER's Rule change proposal is adopted. The NSP's proposal would be accorded no greater role in the process than any other stakeholder submission. While the AER says that it will, in practice, still begin the process with a proposal from the NSP[80], the AER would not have proposed Rule changes that encompass removing the requirement to determine substitute forecasts using a DNSP's proposal as the starting point unless it intended to change existing practice. Thus, rather than effecting a

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[74] AER Draft Rules, pp23, 25, 88, 91 (proposed clauses 6.5.6(c), 6.5.7(c), 6.12.1(2), 6.12.1(3), 6.12.1(4), 6A.6.6(c), 6A.6.7(c), 6A.14.1(1)).

[75] AER Rule Change Proposal, p30.

[76] AER Rule Change Proposal, p30.

[77] AER Rule Change Proposal, p31.

[78] Clause 6.12.3(d) of the Rules; AER Draft Rules, p51.

[79] Clause 6.12.3(f) of the Rules; AER Draft Rules, p51.

[80] AER Rule Change Proposal, p30.

'consider-determine' model, the AER's proposed Rule changes are better characterised as effecting an 'AER determination' model.

The Businesses consider that such a fundamental change to the existing framework under the Rules for the setting of expenditure forecasts should not be effected on the basis of mere assertion. No change should be made unless there is a material deficiency in that framework that has been substantiated by robust evidence following thorough consideration.

At the outset, the Businesses observe that the deficiency in that framework asserted by the AER is not that the expenditure forecasts set in transmission and distribution determinations made under the existing Rules exceed efficient, prudent and realistic expenditure. The asserted deficiency is that, there being no single 'correct' or 'best' estimate of efficient, prudent and realistic expenditure, the expenditure forecasts set in those determinations are at the higher end of the range of efficient, prudent and realistic expenditure. The AER, in essence, seeks a discretion to determine expenditure forecasts unconstrained by an NSP's forecasts, leaving it free to decide what it considers to be a 'best' or 'preferred' estimate.

The existing Rule requirements for the AER to accept an NSP's expenditure forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure are the result of a deliberate and well considered policy decision by the AEMC.

In establishing the existing Rule requirements in Chapter 6A of the Rules, the AEMC gave extensive consideration, with the benefit of lengthy and informed debate and Counsel advice, to the appropriate balance to be struck between market failure and the potential for regulatory error which may result in particular to costs and inefficiencies in relation to investments.[81] It concluded that, there being no 'unique', 'correct' or 'best' estimate of future expenditure requirements'[82], the AER should be required to 'accept the TNSP's forecast "if it is satisfied" that the forecast "reasonably reflects" efficient costs, the costs a prudent operator in the circumstances of the TNSP would require and a realistic expectation of demand and cost inputs'.[83] Such an approach was considered to address the potential for regulatory failure by establishing objective and operationally focused constraints on the AER's exercise of judgment and so ensuring that the AER was 'not at large' in rejecting TNSPs' expenditure forecasts.[84]

In so doing, the AEMC considered submissions that such an approach would potentially bias regulatory decisions towards the higher bound of estimates considered by the AER to be reasonable and limit the AER's discretion to adopt forecasts it considered 'better' satisfy the expenditure criteria.[85] It nonetheless concluded that the existing Rule requirements strike an appropriate balance between the risks and costs of market and regulatory failure because:[86]

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[81] 2006 TNSP Rule Determination, pp48, 50-52.

[82] 2006 TNSP Rule Determination, pp50, 52.

[83] 2006 TNSP Rule Determination, p51.

[84] 2006 TNSP Rule Determination, p53.

[85] 2006 TNSP Rule Determination, pp50-51.

[86] 2006 TNSP Rule Determination, pp52-53. The AEMC reached substantively similar conclusions in the 2006 TNSP Draft Rule Determination, pp52-53, in response to concerns about strategic behaviour expressed in

- the Rule requirements with respect to expenditure forecasts submitted by NSPs and the content of their regulatory proposals would address issues of information asymmetry and facilitate AER scrutiny, as well as providing a basis for informed stakeholder consultation; and

- the risk that exaggerated forecasts would fail to satisfy the assessment criteria and be rejected by the AER and replaced by a less favourable forecast would reduce the incentive for ambit claims by NSPs.

The AEMC emphasised that '[t]he decision-making framework to be applied by the AER to the TNSPs' proposals in relation to expenditure forecasts ... needs to be considered and evaluated in the broader context of the regulatory framework as a whole and the balance it achieves between the competing policy objectives and interests that are involved'.[87]

The AEMC's rationale for the existing Rule requirements for the AER to accept an NSP's expenditure forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure remains valid.

Further, it is premature to revisit that rationale and the resultant Rule requirements until information is available for at least one regulatory control period on how NSPs' actual expenditure compared to expenditure forecasts in transmission and distribution determinations made under the existing Rule framework. Whereas there are a range of reasons for increases in an NSP's expenditure requirements between periods in recent years that explain expenditure forecasts under the existing framework that exceed their actual expenditure in prior periods, differences between expenditure forecasts under that framework and actual expenditure incurred in the same period would provide greater insight into the accuracy of expenditure forecasting. While differences between any given NSP's expenditure forecasts and actual expenditure are to be expected, a systematic divergence between expenditure forecasts and actual expenditure across NSPs could be expected to provide an insight into the operation of the existing expenditure assessment framework.

In any event, the AER has failed to demonstrate any deficiency in the existing Rule requirements under Chapters 6 and 6A to accept an NSP's expenditure forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure and to amend those forecasts 'only to the extent necessary' to enable them to be approved in accordance with the Rules.

The AER does not substantiate its key assertion that 'inflated forecasts have been a factor in the price rises faced by consumers'.[88] Nor does the available evidence support its assertion.

The fact that the expenditure forecasts and allowed revenues accepted in the AER's transmission and distribution determinations to date have generally been higher than in previous periods does not establish that those forecasts and allowed revenues have been 'systematically inflated' or that this has contributed to increasing network charges. As the AER itself acknowledges,[89] there are a range of other reasons for increasing network charges, including for example an ageing asset base, higher

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the Expert Panel on Energy Access Pricing's *Report to the Ministerial Council on Energy* of April 2006 that predated that Determination.

[87] 2006 TNSP Rule Determination, p49.

[88] AER Rule Change Proposal, p14.

[89] AER Rule Change Proposal, p6.

reliability standards, the effects of the GFC on the costs of capital, and a combination of increasing peak demand and declining sales.

The available evidence discloses that the existing framework, in particular the requirement under Chapters 6 and 6A to accept an NSP's expenditure forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure, has not operated to restrict the AER's ability to reject NSPs' expenditure forecasts. An examination of the AER's transmission and distribution determinations made to date discloses that the AER has rejected both the opex and capex forecasts put forward by NSPs in *every* determination and substituted forecasts of opex and capex it considered to reasonably reflect the opex and capex criteria. The following Table 1 sets out the percentage changes to the NSPs' forecasts of total required opex and capex made by the AER in determining substitute forecasts in its determinations to date.

	Opex	Capex
DNSP Determinations		
CitiPower	-14%	-19%
Powercor Australia	-14%	-18%
JEN	-17%	-25%
SPI	-11%	-8%
United Energy	-14%	-8%
ETSA Utilities	-5% (-4%*)	-11%
Ergon Energy	-6% (-5%*)	-20% (-19*)
Energex	-1%	-8%
Country Energy	-7%	-4%
EnergyAustralia (now AusGrid)	-12% (-12%*)	-6%
Integral Energy	-0.3%	-0.5%
ActewAGL Distribution	-5%	-8%
TNSP Determinations		
Transend	-10%	-15%
TransGrid	-6% (-5%*)	-4%
ElectraNet	-1%	-10%
SP AusNet	-10%	-10%

* Represents the difference between the NSP's revised proposal and the final expenditure forecast following the appeal of the AER's determination to the Tribunal.

Table 1 - Percentage changes to NSPs' opex and capex forecasts made by AER in determining substitute forecasts in its determinations[90]

[90] These figures are sourced from a joint report by PwC, Gilbert+Tobin and NERA for the ENA, *Assessment of the AER's Rule Change Proposal in Relation to Forecast Expenditure*, December 2011, which has been submitted to the AEMC by the ENA.

The rejection by the AER of *every* NSP forecast of opex and capex in its determinations to date suffices to establish that, in practice, the AER has not been confined to accepting any NSP expenditure forecast by reason of the Rule requirement for it to accept an NSP's expenditure forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure.

The AER states, in its Rule Change Proposal, that the fact that the AER has, in its determinations, rejected NSPs' opex and capex forecasts and substituted its own forecasts does not establish that the existing framework is working well. The AER contends that this is evidenced by the fact that the AER's substitute forecasts have nonetheless represented significant increases on past expenditure levels. It cites, by way of example, the AER's reduction of TNSPs' capex forecasts, on average, by 11 per cent, observing that the capex forecasts determined by the AER still represented a 64 per cent increase on actual expenditure under the previous framework and that the AER 'is not confident that this represents efficient or necessary expenditure'.[91]

As the AER itself acknowledges there are no limitations under Chapter 6A on the AER's power to determine substitute expenditure forecasts for TNSPs that it is satisfied reasonably reflect the NSP's efficient, prudent and realistic expenditure where it has rejected the NSP's expenditure forecasts. The AER's reliance on the AER's determination of substitute capex forecasts for TNSPs to illustrate the proposition that the existing framework does not work well where it has rejected an NSP's forecasts and must determine substitute forecasts is therefore surprising. Given the lack of any limitation on the AER's power to determine substitute expenditure forecasts by reference to the NSP's proposal or forecasts under Chapter 6A, the AER's stated concerns regarding the efficiency and need for capex by TNSPs in the amount determined by the AER in its determinations cannot be ascribed to any deficiency in the Rules. Rather, those concerns (if valid) would be explicable only by the AER's failure to discharge its obligation under Chapter 6A of the Rules to determine substitute forecasts that it is satisfied reasonably reflect the TNSP's efficient and prudent expenditure.[92]

Even under Chapter 6 which requires the AER to amend a DNSP's expenditure forecasts 'only to the extent necessary' in determining substitute forecasts, the fact that the AER's substitute forecasts in the AER's transmission and distribution determinations to date have generally been higher than actual expenditure incurred by NSPs in previous periods does not establish that those AER substitute forecasts have been 'inflated' or represent the upper end of a 'reasonable' range of efficient, prudent and realistic expenditure. Actual expenditure incurred by an NSP in a previous period does not represent an 'unbiased' estimate of the NSP's future efficient, prudent and realistic expenditure. There are a range of other reasons for increases in an NSP's expenditure requirements between periods including in particular in recent years, including for example those acknowledged in the AER Rule Change Proposal[93], namely an ageing asset base, higher reliability standards, the effects of the GFC on the costs of capital, and a combination of increasing peak demand and declining sales.

The AER's rationale for removing the existing Rule requirements for it to accept an NSP's expenditure forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure and amend those forecasts 'only to the extent necessary' to enable them to be approved in accordance with the Rules is also premised on the Rules being interpreted as precluding

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[91] AER Rule Change Proposal, p14.

[92] Clause 6A.13.2(b) of the Rules.

[93] AER Rule Change Proposal, p6.

it from rejecting an NSP's forecasts where those forecasts are within the 'reasonable' range of estimates of efficient, prudent and realistic expenditure.

The Tribunal's decision in *Application by Ergon Energy Corporation Limited (Labour Cost Escalators) (No 5)* [2010] ACompT 11 casts doubt on the correctness of this premise. In that decision, the Tribunal considered the interpretation and operation of clause 6.5.6(c), which establishes the requirement for the AER to accept a DNSP's opex forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure, concluding as follows:[94]

> It is axiomatic that there will be no one correct or best figure derived from a forecast that in terms of cl 6.5.6(c) 'reasonably reflects' the opex criteria - the very nature of forecasting means that there can be no one absolute or perfect figure. Different forecasting methods are more likely than not to produce different results. Simply because there is a range of forecasts and a DNSP's forecast falls within the range does not mean it must be accepted when, as here, the AER has sound reason for rejecting the forecast.
>
> First, cl 6.5.6(c) of the Rules does not require the AER to identify a range of forecasts and determine whether a DNSP's forecast falls within that range. Nor is there anything in the legislation under consideration here that requires the AER to accept a figure advanced by a DNSP simply because it may be within a range of figures the DNSP may point to as reasonable. As submitted by the AER, cl 6.5.6(c) does not require it expressly nor is such a requirement implicit in the clause.
>
> Secondly, what cl 6.5.6(c) requires is the AER to accept a forecast if it is satisfied that the forecast reasonably reflects the opex criteria. The AER pointed to cl 6.1.2(3) of Sch 6.1 to the Rules which requires a DNSP to explain the method by which its forecasts have been developed, as making good its claim that the requirement of cl 6.5.6(c) extends beyond mere examination of figures to an examination of how those figures are arrived at. In this respect, the reasons advanced by the AER ... for rejecting a forecast based on the outcome of industrial wage negotiations are sound...

In any event, there is no evidence, in its transmission and distribution determinations to date, that the AER has identified a range of forecasts and determined whether the NSP's forecast falls within that range.

Further, the AER's contention that the existing Rule requirements limit its ability to interrogate and amend those forecasts[95] is inconsistent with its own submissions to the Tribunal in the current Victorian DNSPs review. In that review, the Minister for Energy and Resources for the State of Victoria contends that the AER's decision to apply actual rather than forecast depreciation in determining the opening RAB for Victorian DNSPs for the 2016-20 regulatory control period was subject to reviewable error because (amongst other reasons) it creates incentives for 'over forecasting' by DNSPs. The AER responded by asserting that the Minister's concern regarding over forecasting was 'more apparent than real' because Chapter 6 of the Rules (together with Division 3A of Part 6 of the Law) creates two 'layers of review' of a DNSP's capex forecasts, being the requirement for the AER not to accept a DNSP's forecasts if it is not satisfied that the forecast reasonably reflects the capex criteria and the potential for Tribunal review of the AER's decision to accept or determine substitute capex forecasts.[96] In oral submissions, Counsel for the AER expanded on this submission as follows:[97]

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[94] *Application by Ergon Energy Corporation Limited (Labour Cost Escalators) (No 5)* [2010] ACompT 11, [69]-[71].

[95] AER Rule Change Proposal, p13.

[96] *The Australian Energy Regulator's Outline of Submissions in relation to RAB Depreciation* dated 18 March 2011, [23]-[24].

[97] Transcript of Victorian DNSPs Review, 5 July 2011, p490, lines 5-15.

> ...the AER has not simply accepted the figures which the DNSPs sought. So the DNSPs can forecast as much as they wish as to what they say is the appropriate opex and capex, but ... the amounts which was [sic] granted for both, relevantly here for capex was materially less than what was sought by the DNSPs, ... and that makes the point which was just being touched upon: that there's an assumption by the Minister that the forecast capex is unreasonable and inefficient, and that assumption is really assertion...

It is difficult to reconcile these AER contentions before the Tribunal with the AER's current contention that it has limited ability to interrogate and amend DNSPs' forecasts under the existing Rules framework for expenditure forecasts.

Finally, the Businesses observe that the risk of 'systemically inflated forecasts' does not exist in respect of opex forecasts given the AER's approach to assessing and determining opex forecasts, which approach is necessitated by other elements of the regulatory framework. The AER's adoption of a 'revealed cost' approach to opex forecasting, pursuant to which forecast opex for a regulatory control period is based on actual expenditure incurred in a 'base year' (generally the penultimate year of the preceding period) is critical to the delivery, and thus necessitated, by the efficiency benefit sharing scheme of incentives for the incurring of efficient opex. The NSP's ability to 'inflate' opex forecasts is constrained by the use of its actual opex incurred in the base year as the basis for forecasting and the efficiency benefit sharing scheme, in turn, constrains the NSP's actual opex by creating strong incentives for NSPs to realise efficiencies in incurring opex. Against this background, the AER's rationale for proposing to remove the existing Rule requirements to accept an NSP's *opex* forecasts where those forecasts 'reasonably reflect' the NSP's efficient, prudent and realistic expenditure is unclear.

Requirement for AER to determine substitute forecasts 'on the basis of' the DNSP's current regulatory proposal

The AER has also failed to demonstrate any deficiency in the existing Chapter 6 requirement for the AER to determine substitute forecasts 'on the basis of' the DNSP's current regulatory proposal.

The AER's primary assertion is that this requirement requires it to determine substitute forecasts 'in the same manner as determined by the DNSP in their proposal'.[98] However, the Tribunal decision in *Application by EnergyAustralia and Others* [2009] ACompT 8 (12 November 2009) establishes that it is open to the AER to reject a DNSP's opex forecast on the basis of the methodological approach adopted and, where it does so, to depart from, rather than amend, that methodology in determining a substitute forecast.[99]

The AER further asserts this requirement also requires it to undertake a 'line by line assessment' of the NSP's 'bottom up' calculation of its forecasts. The Businesses consider a careful and thorough assessment of this kind is desirable and consistent with the AEMC's apparent intent in establishing information disclosure requirements for NSPs' proposals and expenditure forecasts.[100] In any event, the AER's transmission determinations to date disclose that it has adopted a bottom up, line by line assessment approach to TNSP's expenditure forecasts despite the absence of any limitation under

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[98] AER Rule Change Proposal, pp13, 26, 29.

[99] *Application by EnergyAustralia and Others* [2009] ACompT 8, [253]-[256].

[100] 2006 TNSP Rule Determination, pp 48-49, 52; clause 6.3.1(3) and schedule 6.1, and clause 6A.10.2 and schedule 6A.1.1, of the Rules.

Chapter 6A of the Rules on the AER's power to determine substitute forecasts by reference to the TNSP's revenue proposal.[101]

The Businesses disagree with the consequences said by the AER to flow from the requirement to conduct such a 'line by line assessment'. Addressing each of those consequences in turn:

- The AER asserts that it is prevented from weighing all available information, data and evidence, including in particular benchmarking but:
    - the existing Rule provisions expressly provide for the use of benchmarking and the consideration of all available information, data and evidence by the AER;[102] and
    - the AER has undertaken benchmarking in its distribution determinations to date and any reduced weight accorded to that benchmarking has been expressly accorded by the AER to its concerns with the inherent limitations of benchmarking techniques and the availability and methods of standardisation of input data, rather than any constraint on the use of that benchmarking by reason of the Rules.[103]
- The AER asserts that it is subject to a high evidentiary burden not envisaged by the AEMC at the time of establishing Chapter 6A but:
    - while, as a practical matter, it initially lies with a NSP to put before the AER material which demonstrates that its expenditure forecasts satisfy the expenditure criteria, the Rules do not impose any onus or burden of proof on the AER but rather require it to construe and apply the Rule provisions governing its assessment of those expenditure forecasts;[104]
    - any 'evidentiary burden' experienced by the AER as a practical matter is a consequence of the information disclosure requirements imposed on NSPs in respect of their expenditure forecasts under the Rules[105] and the issuing by the AER of detailed regulatory information notices under the Law in determination processes, not any obligation to undertake a careful and thorough consideration of the information put before it by the NSP; and

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[101] Clause 6A.13.2(b) of the Rules; Transend, TransGrid, ElectraNet and SP AusNet Transmission Determinations Final Decision.

[102] Clauses 6.5.6(e)(1)-(4), 6.5.7(e)(1)-(4) of the Rules.

[103] For example: Appendices to the Victorian Distribution Determinations Final Decision, Appendix H, pp94-116 (see, in particular, section H.3.1.3, p99); Appendices to the South Australian Distribution Determination Final Decision, Appendix I, pp357-370; South Australian Distribution Determination Draft Decision, p200.

[104] Williams SC and Higgins, *Memorandum of Advice In the Matter of the Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, 24 October 2006, pp1-3, 13-15, [2.1], [25]-[30].

[105] Clause 6.3.1(3) and Schedule 6.1 of the Rules.

- these requirements were expressly contemplated by the AEMC as a means of addressing information asymmetry and facilitating AER scrutiny of NSPs' expenditure forecasts.[106]

- The AER asserts that the resultant assessment process is inconsistent with the current incentive framework, pursuant to which NSPs are to efficiently prioritise expenditure based on changing priorities and circumstances in order to meet required service levels but NSPs have strong incentives under the regulatory framework (through, for example, the use of actual rather than forecast depreciation to determining opening RAB values and the efficiency benefit sharing scheme) to seek out efficiencies and the framework enables them to respond to changing priorities and circumstances in determining their mix of actual expenditure in doing so, and the AER's approach to assessment of expenditure forecasts does not alter this.

Summary

The Businesses consider that the existing Rules framework for expenditure forecasting promotes the NEO and the RPPs because the existing framework strikes the appropriate balance between the risks and costs of market and regulatory failure. It was for this very reason that the AEMC concluded that the NEO was best promoted by, and thus established, the existing requirement for the AER to accept NSPs' expenditure forecasts where those forecasts 'reasonably reflect' efficient, prudent and realistic expenditure. By contrast, the AER has failed to demonstrate any deficiency in the existing Rules framework or, therefore, that the making of its proposed Rule changes would contribute to a more effective achievement of the NEO and the RPPs.

A.2 EXPENDITURE OBJECTIVES, FACTORS AND CRITERIA

AER Rule Change Proposal

Current Rule provisions

The existing Rule provisions establish a set of opex and capex objectives that constitute the matters that the expenditure forecasts are required to achieve. These include meeting or managing the expected demand, complying with all applicable regulatory obligations or requirements, maintaining the quality, reliability and security of supply and maintaining the reliability, safety and security of the system.[107]

As discussed in section A.1 of this Annexure A above, the Rules require the AER to accept an NSP's expenditure forecast where it is satisfied that forecast 'reasonably reflects' the expenditure criteria, being the efficient costs of achieving the expenditure objectives, the costs a prudent operator in the circumstances of the relevant NSP would require to achieve those objectives and a realistic expectation of the demand forecast and cost inputs required to achieve those objectives.[108]

Finally, the Rules require the AER, in deciding whether or not the AER is so satisfied, to have regard to the expenditure factors. These expenditure factors, to which the AER 'must have regard', relevantly include factors relating to the information, submissions and analysis to which the AER is

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[106] 2006 TNSP Rule Determination, pp48-49, 52.

[107] Clauses 6.5.6(a), 6.5.7(a), 6A.6.6(a), 6A.6.7(a) of the Rules.

[108] Clauses 6.5.6(c), 6.5.7(c), 6A.6.6(c), 6A.6.7(c) of the Rules.

to have regard in making determinations, most notably 'analysis undertaken by or for the *AER* and *published* before the distribution determination is made in its final form'.[109]

AER's characterisation of 'the problem'

While the AER raises a concern with the expenditure objectives, it considers this matter is best addressed through the AEMC's impending review of distribution reliability standards.[110]

The AER considers the expenditure criteria are no longer required under its proposal for the expenditure assessment framework, discussed in section A.1 above. Instead, the AER proposes that the first and second of the expenditure criteria, relating to efficiency and prudency, be incorporated in its proposed statutory test for forecast expenditure to the extent appropriate.[111]

With respect to the second criterion, however, the AER contends that the existing qualification by reference to 'the circumstances of the relevant [NSP]' 'may limit the AER's ability to apply comparative analysis and benchmarking in identifying efficient costs'.[112] The AER concedes that 'good benchmarking practice requires that the characteristics of the individual network be taken into account in the normalisation of the data, including matters such as network topography'. [113] However, the AER considers that there is a 'possible tension' between the identification of efficient costs and the requirement to take into account the individual circumstances of the NSP and, accordingly, the circumstances and characteristics of an NSP to which regard is had should be a matter for the AER's exercise of regulatory judgment[114].

The AER considers the first three expenditure factors relating to the information, submissions and analysis to which it is to have regard are procedural in nature, don't add anything substantive to the assessment of forecasts against the expenditure criteria and may create ambiguity as to whether specific weight must be accorded to them and how they are to be balanced with other factors. It further considers that the existing factor relating to 'analysis undertaken by or for the *AER* and *published* before the distribution determination is made in its final form' 'has the potential to make decision making processes unworkable within the prescribed timeframes' by creating a cycle of publication of analysis and submissions, and an associated opportunity for gaming and delay.[115]

The AER also considers that clarifications to the expenditure factors are required to avoid any potential for doubt or uncertainty regarding their meaning and operation, and to enable the AER to consider whether, on the introduction of a contingent project framework for DNSPs in Chapter 6, an element of a capex forecast may be more appropriately provided for as a contingent project. This

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[109] Clauses 6.5.6(e), 6.5.7(e), 6A.6.6(e), 6A.6.7(e) of the Rules.

[110] AER Rule Change Proposal, p33.

[111] AER Rule Change Proposal, p33.

[112] AER Rule Change Proposal, p33.

[113] AER Rule Change Proposal, p33.

[114] AER Rule Change Proposal, p37.

[115] AER Rule Change Proposal, p34.

potential for doubt is said to include in particular whether the expenditure factors are currently exhaustive or the AER can consider any other factors it considers relevant.[116]

AER's proposed Rule changes

The AER does not propose any amendment of the expenditure objectives.

In proposing to remove the existing Rule requirement for the AER to accept an NSP's expenditure forecast where that forecast 'reasonably reflects' the expenditure criteria, the AER also proposes to remove those criteria from the Rules.[117] The requirement for the AER to determine the forecast it 'considers would meet the efficient costs that a prudent [NSP] would require to achieve the [expenditure] objectives' that the AER proposes replace the existing requirement incorporates some but not all of the expenditure criteria in the statutory test for expenditure forecasts.[118] In particular, whereas one of the existing expenditure criteria is 'the costs that a prudent operator in the circumstances of the relevant [NSP] would require to achieve the [expenditure] objectives', the AER's proposed statutory test for expenditure forecasts refers only to the costs that the hypothetical prudent NSP would require to achieve those objectives without any qualifying requirement to consider the prudent NSP 'in the circumstances of the relevant [NSP]'.

The AER also proposes the amendment of the expenditure factors to:

- render the expenditure factors permissive rather than mandatory considerations (i.e. factors to which the AER 'may, as it considers appropriate', rather than 'must', have regard);[119]
- relocate a number of expenditure factors relating to the information, submissions and analysis to which the AER is to have regard, including in particular that relating to 'analysis undertaken by or for the *AER* and *published* before the distribution determination is made in its final form', to the Rule provisions relating to the making of determinations more generally;[120]
- relocate the existing expenditure criterion with respect to a realistic expectation of the demand and cost inputs in the expenditure factors;[121]
- clarify some existing expenditure factors and, for Chapter 6, establish a new factor in relation to contingent projects;[122] and

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[116] AER Rule Change Proposal, p34.

[117] AER Draft Rules, pp23, 25, 88, 91.

[118] AER Draft Rules, pp23, 25, 88, 91 (proposed clauses 6.5.6(c), 6.5.7(c), 6A.6.6(c), 6A.6.7(c)).

[119] AER Draft Rules, pp23, 26, 89, 91 (proposed clauses 6.5.6(d), 6.5.7(d), 6A.6.6(d), 6A.6.7(d)).

[120] Clauses 6.5.6(e)(1)-(3), 6.5.7(e)(1)-(3), 6A.6.6(e)(1)-(3), 6A.6.7(e)(1)-(3) of the Rules; AER Draft Rules, pp23, 26, 45, 48, 89, 91, 111, 114 (proposed clauses 6.5.6(d), 6.5.7(d), 6.10.1(c), 6.11.1(d), 6A.6.6(d), 6A.6.7(d), 6A.12.1(a)(3), 6A.13.1(a)(3)).

[121] AER Draft Rules, pp24, 26, 90, 92 (proposed clauses 6.5.6(d)(8), 6.5.7(d)(8), 6A.6.6(d)(11), 6A.6.7(d)(11)).

- provide for the AER to consider 'any other factors the *AER* considers relevant'.[123]

In relocating the expenditure factors relating to the information, submissions and analysis to which the AER is to have regard to the Rule provisions relating to the making of determinations, the AER proposes requirements for it, in making its draft and final determinations, to 'have regard to analysis undertaken by or for the *AER*'.[124] In so doing, the qualification on the analogous expenditure factor by reference to publication of that analysis before the final determination is made is omitted by the AER.

Businesses' Response

Businesses three objections to AER Rule Change Proposal

The Businesses disagree with three aspects of the AER's proposed changes in respect of the expenditure criteria and expenditure factors, as follows:

- First, the Businesses consider that the 'circumstances of the relevant [NSP]' qualification on the existing expenditure criterion relating to the costs that a prudent operator would require to achieve the expenditure objectives should be retained. If (contrary to the submissions of the Businesses in section A.1 above) the AEMC is minded to make the AER's proposed changes to the expenditure assessment framework, the Businesses submit that the statutory test for expenditure forecasts proposed by the AER should be amended so as to retain this aspect of the existing expenditure criteria.

- Secondly, the Businesses contend that the AER should continue to have a mandatory obligation to consider the expenditure factors. The AER's proposed amendments to render these factors permissive considerations should not be accepted.

- Thirdly, the Businesses object to the AER's proposal for the imposition on it of an obligation to consider analysis undertaken by or for the AER in circumstances where that analysis has not been the subject of publication and consultation prior to the making of the final determination.

The Businesses address each of these matters, in turn, below.

'In the circumstances of the relevant [NSP]' should be retained

The Businesses consider that the requirement to take into account 'the circumstances of the relevant [NSP]' in determining the efficient and prudent costs required to achieve the expenditure objectives is critical to ensuring that the AER considers the operating environment of the relevant NSP, this operating environment being the key determinant of the cost structure of the NSP. In the absence of this requirement, it would be open to the AER to determine on an expenditure forecast that reflects the efficient costs of a hypothetical NSP that bears no relationship to the efficiency gains achievable by the relevant NSP acting prudently and the resultant expenditure required by that NSP, acting efficiently and prudently, to achieve the expenditure objectives.

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[122] AER Draft Rules, pp24, 26, 89-90, 92 (proposed clauses 6.5.6(d)(5), 6.5.6(d)(7), 6.5.6(d)(9), 6.5.7(d)(5), 6.5.7(d)(7), 6.5.7(d)(9), 6A.6.6(d)(5), 6A.6.6(d)(9), 6A.6.7(d)(5), 6A.6.7(d)(9)).

[123] AER Draft Rules, pp24, 26, 90, 92 (proposed clauses 6.5.6(d)(10), 6.5.7(d)(10), 6A.6.6(d)(12), 6A.6.7(d)(12)).

[124] AER Draft Rules, pp45, 48, 111, 114 (proposed clauses 6.10.1(c), 6.11.1(d), 6A.12.1(a)(3), 6A.13.1(a)(3)).

Further, the Businesses consider the removal of the requirement to take into account the NSP's circumstances is not necessitated by the matters to which the AER refers.

While the AER asserts that the requirement to take into account the NSP's circumstances may limit its ability to apply comparative analysis and benchmarking, there is no evidence of this in practice. As discussed in section A.1 above, the AER has undertaken benchmarking in its distribution determinations to date and any reduced weight accorded to that benchmarking has been expressly accorded by the AER to its concerns with the inherent limitations of benchmarking techniques and the availability and methods of standardisation of input data, rather than any constraint on the use of that benchmarking by reason of the Rules.[125]

While the AER refers to a 'possible tension' between the identification of efficient costs and the requirement to take into account the NSP's circumstances, the same tension exists between the identification of efficient costs and the requirement to consider the costs required by the prudent operator[126] and is retained in the AER's proposed statutory test for expenditure forecasts. These tensions are already a matter within the AER's regulatory judgement. As the Tribunal observed in *Application by Ergon Energy Corporation Limited (Non-system property capital expenditure) (No 6)* [2010] ACompT 12:[127]

> The Tribunal accepts that there is no one correct answer to the question of what are the "efficient", "prudent" and "realistic" costs of achieving a DNSP's capex objectives, since there is no single objective question. Rather, the terms used in cl 6.5.7(c) of the Rules call for evaluation of the particular situation. Moreover, what are "efficient costs" and what is "prudent" are abstract concepts. Making an evaluation as to what are efficient costs and what costs are prudently incurred requires the decision-maker to undertake a process of assessment by reference to relevant considerations, factors or criteria.

Finally, the AER states its intention to consider the circumstances and characteristics of the NSP in undertaking comparative or benchmarking analysis[128] and, in so doing, implicitly acknowledges the desirability of a consideration of the circumstances and characteristics of the NSP. If this is the AER's intent, it is unclear why the AER proposes to omit reference to 'the circumstances of the relevant [NSP]' from the statutory test for expenditure forecasts.

For these reasons, if the AEMC is minded to make the AER's proposed changes to the expenditure assessment framework, the Businesses would propose an alternative Rule change to reinstate the reference to 'the circumstances of the relevant [NSP]' in the statutory test for expenditure forecasts. The Businesses' proposed alternative drafting amendments appear below (clauses 6.5.6(c) and 6.5.7(c)).

Expenditure factors should continue to be mandatory considerations

The AER Rule Change Proposal provides no explanation for the AER's proposal to amend the Rules to remove the AER's existing obligation to have regard to the expenditure factors and instead provide that the AER 'may, as it considers appropriate' have regard to those factors.

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[125] For example, Appendices to the Victorian Distribution Determinations Final Decision, Appendix H, pp94-116. See, in particular, section H.3.1.3, p99.

[126] *Application by EnergyAustralia and Others* [2009] ACompT 8, [141]-[142].

[127] *Application by Ergon Energy Corporation Limited (Non-system property capital expenditure) (No 6)* [2010] ACompT 12, [17].

[128] AER Rule Change Proposal, p37.

The Businesses observe that the establishment of an obligation, rather than a discretion, for the AER to have regard to the expenditure factors was the result of a deliberate policy decision by the AEMC. This obligation was an important element of the Rule provisions intended by the AEMC to constrain and guide the AER's exercise of judgement in assessing expenditure forecasts.[129] In the 2006 TNSP Draft Rule Determination in particular, the AEMC observed in relation to the expenditure factors (then referred to as the 'criteria for assessing reasonableness'[130]):[131]

> The Commission continues to be of the view that the criteria listed in the Proposed Rule are relevant and appropriate. The Commission notes that the criteria largely reflect current practice, and are supported by the AER. **Codifying the criteria in the Rules, rather than specifying only that the AER should consider the 'reasonableness' of forecasts, provides a greater degree of certainty about how the AER will interpret 'reasonableness' in assessing expenditure forecasts.** The Commission has therefore decided to substantially maintain the list of criteria in the Draft Rule.
>
> [Emphasis added in bold.]

While the AEMC 'revised the structure and wording of the decision criteria to be applied in determining expenditure forecasts' in its 2006 TNSP Rule Determination[132], it nonetheless maintained its view that the AER should be subject to an obligation to have regard to the expenditure factors (referred to in the Determination as 'evidentiary matters'[133]) concluding as follows:[134]

> Under the Revenue Rule, the AER is required to exercise judgement in deciding whether it is satisfied that the forecasts reflect the specified criteria, having regard to the specified factors. However, the exercise of that judgement is constrained and guided by the need to be satisfied as to the efficiency and prudency of the forecast and that the cost forecasts reflect realistic expectations. In exercising its judgement the AER must also have regard to the information provided in the TNSPs proposal and the other evidentiary considerations specified in the Rule. That is, the AER is not at large in being able to reject the TNSPs forecast and replace it with its own. It must also provide reasons in terms of the decision criteria and the factors for both a rejection of the forecasts and their replacement with forecasts that it considers do meet the requirements of the Rules.

The Businesses agree with the view, expressed by the AEMC at that time, that the AER's obligation to have regard to the expenditure factors delivers certainty as to the matters to which the AER must have regard in making its determination and, thus, decreases the risk of regulatory error in, and increases the predictability of, decision making. In circumstances where the AER has advanced no countervailing considerations as a basis for its proposal to change the expenditure factors from mandatory to permissive considerations, that proposal should be rejected.

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[129] 2006 TNSP Rule Determination, pp43-44, 53; 2006 TNSP Draft Rule Determination, pp53-56.

[130] It is readily apparent from a cursory comparison of the list of the criteria for assessing reasonableness appearing in the 2006 TNSP Draft Rule Determination at page 53 and the existing expenditure factors in the Rules that the references to the 'criteria for assessing reasonableness' in the 2006 TNSP Draft Rule Determination are a reference to the existing expenditure factors in the Rules.

[131] 2006 TNSP Draft Rule Determination, p55.

[132] 2006 TNSP Rule Determination, p51.

[133] It is readily apparent from a cursory comparison of the list of 'evidentiary matters' appearing in the 2006 TNSP Rule Determination at page 51 and the existing expenditure factors in the Rules that the references to the 'evidentiary matters' in the 2006 TNSP Rule Determination are a reference to the existing expenditure factors in the Rules.

[134] 2006 TNSP Rule Determination, p53.

Proposal for an AER obligation to consider analysis undertaken by or for it that has not been published prior to making of the final determination should be rejected

The intent of confining the existing expenditure factor relating to analysis undertaken by or for the AER to analysis published before the determination is made in its final form was to ensure that the analysis considered and relied on by the AER in making that determination had been made available for public comment. In the 2006 TNSP Draft Rule Determination, the AEMC explicitly observed that this was the rationale for limiting the requirement for the AER, in making its final determination, to have regard to analysis undertaken by or for it in this manner. The AEMC relevantly stated:[135]

> The Commission ... notes that the reference to 'published' analysis is intended to ensure that analysis conducted by, or on behalf of, the regulator is made available for public scrutiny, improving the transparency of the overall regime'.

By contrast, the proposed obligation would operate to curtail an NSP's (and other stakeholders') right to be heard on issues material to the making of that determination contrary to the AEMC's intent.

The proposed Rule obligation to require the AER to have regard to its own analysis, whether or not that analysis has been published, is also inconsistent with the AER's rationale for proposing a Rule change to confer on the AER a discretion as to the weight to accord confidential information included in NSPs' proposals. The AER's rationale for this Rule change is that this confidential information lacks public scrutiny and comment by stakeholders.[136]

While the AER acknowledges that it 'is bound by administrative law and procedural fairness' in discussing its proposed obligation to consider unpublished analysis undertaken by or for it in making the final determination[137], the AER Rule Change Proposal fails to recognise the potential for conflict between these AER obligations. The proposed obligation empowers the AER to take account of analysis undertaken by or for it in making its final determination where that analysis has not been published prior to that determination and, indeed, requires the AER to do so. The AER's obligation thus conflicts with its obligations under common law and section 16(1)(b) of the Law to accord procedural fairness. Section 16(1)(b) of the Law, in particular, requires the AER to ensure that the NSP to whom the determination would apply and any affected registered participants are, in accordance with the procedures established for this purpose by the Rules, informed of material issues under consideration by the AER and given a reasonably opportunity to make submissions in respect of that determination before it is made.

This inconsistency between the AER's proposed Rule obligation and its existing obligations under common law and section 16(1)(b) of the Law:

- demonstrates an inconsistency between that proposed obligation and the NEO and RPPs, as it should be assumed that the provisions of the Law have been enacted because the legislature considered they promote the NEO and RPPs; and
- may operate to render the proposed Rule provisions effecting that proposed obligation, if made, invalid by reason of this inconsistency because:

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[135] 2006 TNSP Draft Rule Determination, p55.

[136] AER Rule Change Proposal, pp89-91.

[137] AER Rule Change Proposal, p37.

- the Rules enacted by the AEMC are delegated legislation made and amended under the Law;[138] and

- delegated legislation is invalid to the extent that it would, if valid, have an effect inconsistent with the operation of the parent Act, other Acts or the common law (including the common law on procedural fairness).[139]

The Businesses are concerned that, even where the AER's obligation to have regard to its own analysis is confined to analysis published prior to the making of the final determination, the Rules would not preclude the AER from relying on analysis in making its final determination that has not been made available to the relevant NSP for comment. Further, while the AER asserts that it would be required to make details of any analysis relied on in making its final determination available as part of its reasons for decision,[140] the Businesses do not agree that this is unambiguously required by the Rule provisions to which the AER refers.[141] Those provisions require the AER's reasons for decision to set out details of the methods, values adopted in and details of any assumptions made by the AER in undertaking, any analysis or calculations but do not expressly require those reasons to provide the analysis or calculations themselves.

In practice, the AER has, in making distribution determinations for the Businesses, failed to provide the Businesses with analysis and calculations which were determinative of the AER's decision on significant components of their expenditure forecasts either prior to the making of its determinations for comment or in its reasons for decision. In making CitiPower and Powercor Australia's recent Distribution Determinations, in particular, the AER failed to disclose its analysis of the Businesses' required opex for compliance with its vegetation line clearance obligations (being the single largest component of Powercor Australia's opex) prior to or at the time of making those Determinations. The AER provided to CitiPower and Powercor Australia only a description of its approach to the analysis of the Businesses' proposed vegetation management opex and calculation of substitute forecasts, with key data masked for reasons of third party confidentiality, and only at the time of making those Determinations.[142]

The Businesses submit that an obligation for the AER to publish any analysis undertaken by or for it that is relied on in making a final determination for public comment prior to that determination and in its reasons for decision is desirable to:

- mitigate the risk of regulatory error in the making of the determination; and

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[138] Rule 1.2 of the Rules; sections 88, 90, 90A, 90B and 90C of the Law.

[139] See Dennis Pearce and Stephen Argument, *Delegated Legislation in Australia* (3rd edition, 2005) at [19.1], [19.9], [19.10], [19.31]. With respect to repugnancy of a delegated instrument to common law, Pearce and Argument observe that the jurisprudence establishes that, in the absence of clear authority allowing it, delegated legislation may not empower an authority to deny a person procedural fairness in reaching a decision affecting a person.

[140] AER Rule Change Proposal, p37.

[141] Clauses 6.12.2, 6A.14.2 of the Rules.

[142] Appendices to the Victorian Distribution Determinations Final Decision, Appendix L, section L.5.1.2 pp276-301.

- facilitate an assessment of whether there has been any regulatory error in the making of the determination prior to commencing review proceedings in the Tribunal, so ensuring a review is commenced only where the NSP has first verified its view that the review is required to correct error.

By way of example, CitiPower and Powercor Australia sought review by the Tribunal of the AER's decision to reject the Businesses' proposed vegetation management opex and its determination of substitute forecasts and are currently awaiting the Tribunal's decision on that review. While the Businesses were provided with the AER's relevant analysis during the course of the review and consider that analysis confirms the existence of regulatory error, CitiPower and Powercor Australia consider that:

- the regulatory error alleged was avoidable and would not have been made if the AER had made its analysis available for comment before makings its determinations; and

- may have resulted in the unnecessary incurring of resources by the Businesses, the AER and the Tribunal had CitiPower and Powercor Australia commenced the review but subsequently determined, on receipt of the AER's analysis during the review process, that no regulatory error had occurred.

For these reasons, the Businesses propose an alternative Rule change to:

- confine the AER's obligation to have regard to analysis undertaken by or for it in making a determination to analysis published prior to the making of the determination; and

- require the AER to publish any analysis undertaken by or for it that is relied on in making a final determination for public comment prior to the making of that determination.

The Businesses' proposed alternative drafting amendments appear below (clauses 6.10.1(c)-(d), 6.11.1(d)-(e) and 6.12.2(5)).

Summary

The Businesses consider the AER's proposal for removal of the requirement to take into account 'the circumstances of the relevant [NSP]' in determining the efficient and prudent costs required to achieve the expenditure objectives will detract from the achievement of the NEO and the RPPs because, in the absence of this requirement, the statutory test for expenditure forecasts would be satisfied by an expenditure forecast that reflects the efficient costs of a hypothetical NSP that bears no relationship to the efficiency gains achievable by the relevant NSP acting prudently and the resultant expenditure required by that NSP, acting efficiently and prudently, to achieve the expenditure objectives. Further, the matters to which the AER refers as the basis for the removal of this requirement do not justify the proposed change. As such, the AER's proposal for the removal of this requirement creates increased risk that the expenditure forecasts determined by the AER will not provide the NSP with a reasonable opportunity to recover its efficient costs or promote efficient investment in, and the operation and use of, electricity services, without delivering any compensating benefits.

The AER's proposal to amend the Rules to render the expenditure factors permissive, rather than mandatory, considerations can be expected to reduce certainty as to the matters to which the AER is to have regard in makings its determinations and, thus, increase the risk of regulatory error in, and decrease the predictability of, decision making. This will necessarily detract from the achievement of the NEO and the RPPs. As the AER has provided no explanation as to the basis for its proposal

or how the proposal will contribute to the achievement of the NEO and the RPPs, the proposal should be rejected.

Finally, the AER's proposal to establish a requirement to have regard to analysis undertaken by or for it in making determinations without any qualifying requirement that that analysis was first published for public scrutiny increases the risk of regulatory error, so detracting from the achievement of the NEO and the RPPs. The inconsistency between the AER's proposed requirement and its existing obligation under section 16(1)(b) of the Law further demonstrates an inconsistency between that proposed requirement and the NEO and RPPs, as it should be assumed that the provisions of the Law have been enacted because the legislature considered they promote the NEO and RPPs. By contrast, the Businesses' alternative proposed Rule change in relation to the issues raised by the AER Rule Change Proposal promotes the NEO and the RPPs by reducing the risk of, and avoiding the incurring of unnecessary costs in addressing, regulatory error.

6.5.6 Forecast operating expenditure

...

(c) ~~The *AER* must accept the forecast of required operating expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* if the *AER* is satisfied that the total of the forecast operating expenditure for the *regulatory control period* reasonably reflects:~~

~~(1) the efficient costs of achieving the *operating expenditure objectives*; and~~

~~(2) the costs that a prudent operator in the circumstances of the relevant *Distribution Network Service Provider* would require to achieve the *operating expenditure objectives*; and~~

~~(3) a realistic expectation of the demand forecast and cost inputs required to achieve the *operating expenditure objectives*.~~

~~(the *operating expenditure criteria*).~~

The *AER* must determine the total of the forecast of required operating expenditure of a *Distribution Network Service Provider* for the *regulatory control period*, and the forecast of the required operating expenditure for each *regulatory year* of the *regulatory control period*, that the AER considers would meet the efficient costs that a prudent *Distribution Network Service Provider* in the circumstances of the relevant *Distribution Network Service Provider* would require to achieve the *operating expenditure objectives*.

...

6.5.7 Forecast capital expenditure

...

(c) ~~The *AER* must accept the forecast of required capital expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* if the *AER* is satisfied that the total of the forecast capital expenditure for the *regulatory control period* reasonably reflects:~~

~~(1) the efficient costs of achieving the *capital expenditure objectives*; and~~

~~(2) the costs that a prudent operator in the circumstances of the relevant *Distribution Network Service Provider* would require to achieve the *capital expenditure objectives*; and~~

~~(3) a realistic expectation of the demand forecast and cost inputs required to achieve the *capital expenditure objectives*.~~

~~(the *capital expenditure criteria*)~~

The *AER* must determine the total of the forecast of required capital expenditure of a *Distribution*

Network Service Provider for the *regulatory control period*, and for and the forecast of the required capital expenditure each *regulatory year* of the *regulatory control period*, that the AER considers would meet the efficient costs that a prudent *Distribution Network Service Provider* in the circumstances of the relevant *Distribution Network Service Provider* would require to achieve the *capital expenditure objectives*.

6.10 Draft distribution determination and further consultation

6.10.1 Making of draft distribution determination

Subject to the Law and rule 6.14~~(a)~~, the *AER* must:

(a) consider any written submissions made ~~under~~in accordance with rule 6.9;

(b) consider any *regulatory proposal* submitted under rule 6.8 or 6.9;

(c) have regard to analysis undertaken by or for the *AER* and *published* by the *AER* before the draft distribution determination is made; ~~and~~

(d) *publish* any analysis undertaken, or other information, data or material prepared, by or for the *AER* and provide a reasonable opportunity for written submissions on it, before relying on that analysis, information, data or material for the purposes of a distribution determination; and

(e~~d~~) ~~must~~ make a draft distribution determination in relation to the Distribution Network Service Provider.

…

6.11 Distribution determination

6.11.1 Making of distribution determination

Subject to the Law and rule 6.14~~(a)~~, the *AER* must:

(a) consider any submissions made on the draft distribution determination~~, or on~~;

(b) consider any revised regulatory proposal submitted to it under clause 6.10.3;

(c) consider any submissions on any revised *regulatory proposal*;

(d) have regard to analysis undertaken by or for the *AER* and *published* by the *AER* before the distribution determination is made in its final form;~~,~~ ~~and~~

(e) *publish* any analysis undertaken, or other information, data or material prepared, by or for the *AER* and provide a reasonable opportunity for written submissions on it, before relying on that analysis, information, data or material for the purposes of a distribution determination; and

(f~~e~~) ~~must~~ make a distribution determination in relation to the *Distribution Network Service Provider*.

…

6.12.2 Reasons for decisions

The reasons given by the *AER* for a draft distribution determination under rule 6.10 or a final distribution determination under rule 6.11 must set out the basis and rationale of the determination, including:

(1) details of the qualitative and quantitative methods applied in any calculations and formulae made or used by the *AER*; and

(2) the values adopted by the *AER* for each of the input variables in any calculations and formulae, including:

  (i) whether those values have been taken or derived from the provider's current *building block proposal*; and

  (ii) if not, the rationale for the adoption of those values; and

(3) details of any assumptions made by the *AER* in undertaking any material qualitative and quantitative analyses; and

(4) reasons for the making of any decisions, the giving or withholding of any approvals, and the exercise of any discretions, as referred to in this Chapter 6, for the purposes of the determination; and

(5) any calculations, formulae and analysis, whether quantitative or qualitative, undertaken by or for the *AER* and on which it has relied for the purposes of the determination.

A.3 CAPEX INCENTIVES, CONTINGENT PROJECTS AND CAPEX REOPENERS

AER Rule Change Proposal

Current Rule provisions

The Rules provide that to determine the opening RAB for a regulatory control period, the RAB from the beginning of the previous regulatory control period must be:

- increased by the amount of all capital expenditure incurred during the previous control period (or the amount of estimated capex where actual capex is not available);[143]
- reduced by the amount of depreciation of the RAB during the previous period, calculated in accordance with the distribution determination for that period;[144] and
- reduced by the disposal value of any asset where that asset has been disposed of during the previous period, or where that asset is no longer to be used to provide standard control services.[145]

The opening RAB is then used to determine the return on capital and depreciation for each regulatory year within the regulatory period (which amounts are included in the DNSP's annual revenue requirement for that year).[146]

AER's characterisation of 'the problem'

The AER's stated concern is that the current approach to the roll forward of the RAB (i.e. that all actual capex is rolled in), under certain circumstances, creates incentives for DNSPs to incur capex in excess of the efficient level of capex.[147]

Under the current regime, incentives not to overspend are that they bear the financing cost of capex overspend during a regulatory control period, as well as a loss of depreciation (where depreciation is calculated by reference to actual, rather than forecast, capex).[148] The AER raised a concern that the Rules may not provide sufficiently strong incentives to ensure that only efficient investment occurs where:[149]

- the regulated WACC is higher than the actual cost of capital for the NSP. The AER suggests that where the true WACC is lower than the regulated WACC, there is an incentive to overspend; or

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[143] Clauses S6.2.1(e)(1) and (2) of the Rules.

[144] Clause S6.2.1(e)(5) of the Rules.

[145] Clauses S6.2.1(e)(6)-(8) of the Rules.

[146] Clauses 6.4.3, 6.5.2 and 6.5.5 of the Rules.

[147] AER Rule Change Proposal, p37.

[148] AER Rule Change Proposal, p42.

[149] AER Rule Change Proposal, pp38-40.

- the NSP is responding to a broader range of incentives (e.g. reliability standards), rather than just financial incentives.

The AER also observed that DNSPs have stronger incentives to overspend on capex towards the end of the regulatory period because there is a shorter delay before the expenditure is rolled into the RAB (and thus a shorter delay before the expenditure is reflected in the DNSP's annual revenue requirements).[150]

By way of evidence of the incentive on DNSPs to incur capex in excess of efficient capex, the AER cited its estimate that up to 25% of the increases in distribution network charges in New South Wales and Queensland during the most recent round of regulatory resets were attributable to capex in excess of forecasts in the previous period.[151]

AER's proposed Rule changes

The AER proposed a Rule change to allow only 60% of any capex in excess of the AER's forecast capex in the distribution determination to be rolled into the RAB. Specifically, the AER proposed a Rule change to provide for the previous RAB to be increased by:[152]

- the lesser of:
    - the total capex incurred; and
    - total forecast capex determined in the distribution determination; and
- 60% of the total capex that exceeds the total forecast capex determined in the distribution determination.

The AER contended that, on its proposed approach, incentives to overspend on capex would be reduced because only 60% of the capex in excess of the forecast amount would be funded by customers, with the remaining 40% being funded by the NSPs themselves.[153]

The AER submitted that its proposed sharing factor of 40% reflects the outcomes associated with a capex rolling incentive (used in other jurisdictions) assuming a weighted average asset life of 40 years, a regulated WACC of 11% and a true WACC of 11%.[154] A capex rolling incentive scheme applies a lag to the inclusion of capex in the RAB. Accordingly, it would require NSPs to bear the financing costs and additional depreciation associated with overspend for longer than just up until the next regulatory control period (e.g. for a period of five years). The AER indicated that a sharing factor is preferable to a capex rolling incentive scheme because:[155]

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[150] AER Rule Change Proposal, p39.

[151] AER Rule Change Proposal, p38.

[152] AER Draft Rules, p59 (proposed clause S6.2.1(e)(1)).

[153] AER Rule Change Proposal, p40.

[154] AER Rule Change Proposal, p42.

[155] AER Rule Change Proposal, p43.

- it is a relatively simple mechanism, which clearly signals the consequences of overspend to NSPs; and
- the penalty associated with overspend occurs sooner than would be the case if a long lag (e.g. a five year lag) was applied, and thus impacts on the management teams responsible for incurring capex in the relevant regulatory period.

The AER acknowledged that DNSPs would continue to bear the financing cost of capex overspend during a regulatory control period, as well as the loss of depreciation.[156]

To account for uncertainty and unforeseen events that may increase capex above the forecast level, the AER proposed Rule changes in respect of DNSPs to introduce two concepts from the transmission regulatory framework, namely to allow for:

- contingent projects; and
- capex reopeners.

The AER's proposed provision regarding contingent projects would allow the AER to identify in a distribution determination any contingent project in respect of which additional capex would be required if a specified trigger event occurred.[157] The capex for a proposed contingent project must exceed the threshold set out in relevant AER guidelines, or if no such guidelines exist, $10 million.[158] If the AER is satisfied that the trigger event has occurred, it must determine the prudent and efficient cost of undertaking the capex associated with the trigger event and amend the capex forecasts in the distribution determination.[159]

The AER's proposed capex reopener provision provides that the AER must revoke and substitute a distribution determination if:[160]

- an event that is beyond the reasonable control of the NSP, which event could not have been reasonably foreseen by the NSP at the time of the distribution determination, has occurred during the regulatory control period;
- the total capex required during the regulatory period to rectify the adverse consequences of the event:
    - exceeds 5% of the value of the RAB for the first year of the regulatory control period;
    - is such that if undertaken is reasonably likely to result in the actual capex for that regulatory control period exceeding total forecast capex; and

[156] AER Rule Change Proposal, p42.

[157] AER Draft Rules, pp36-37 (proposed clause 6.6A.1).

[158] AER Draft Rules, p36 (proposed clause 6.6A.1(b)).

[159] AER Draft Rules, pp37-39 (proposed clause 6.6A.2).

[160] AER Draft Rules, pp33-34 (proposed clause 6.6.4).

- the NSP can demonstrate that it is not able to reduce capex in other areas to avoid the adverse consequences;

- failure to rectify the adverse consequences of the event would be likely to materially adversely affect the reliability and security of the relevant distribution system.

A proposed 'Note' to the AER's revised RAB roll forward provision provides that the total forecast capex which forms the cap on the amount that can be rolled into the RAB in full may have been substituted after a capex reopener or amended to allow for a contingent project.

Businesses' Response

Capex incentives

As the AEMC would be aware, the decision to allow NSPs to roll all actual capex into the RAB was a deliberate policy decision, designed to ensure NSPs had appropriate incentives to invest in sufficient capacity to maintain service levels amid dynamic demand conditions.[161] It removed the uncertainty that would otherwise face NSPs if an ex-post review of the capex was undertaken.[162]

The Businesses are strong supporters of incentive based regulation and agree that the incentives applied to capex under the current Rules are relatively low powered and could be increased. However, the Businesses do not accept the AER's proposed Rule change. First, the Businesses observe that the AER already has the power to introduce capex incentives under the existing EBSS Rule provisions. Further, the Businesses reject the AER's proposed Rule change on the basis that it:

- is asymmetric, providing only penalties where there is overspend with no rewards for underspend, and does not provide continuous incentives to make efficiency gains throughout the regulatory control period;

- introduces penalties for NSPs for making efficient investment in the network where the actual level of efficient expenditure is higher than forecast;

- fails to take into account potential trade-offs between opex and service standards and any capex incentive regime; and

- locks a particular capex incentive regime into the Rules, rather than (as is the case with the other incentive schemes), allowing it to develop over time and vary as the other incentives facing the NSPs evolve.

At the outset, and while as noted the Businesses do not object to stronger incentives for efficient capex, the Businesses observe that the 'evidence' cited by the AER in support of the need for stronger capex objectives does not support its position.[163] First, while demonstrating that actual capex in New South Wales and Queensland in the last regulatory period was higher than forecast, the AER's discussion does not address whether or not that overspend was efficient. Further the situation in New South Wales and Queensland can be contrasted with the Victorian and South Australian experience, where actual expenditure was about the same as or less than the regulatory

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[161] 2006 TNSP Rule Determination, p99.

[162] 2006 TNSP Rule Determination, p99.

[163] AER Rule Change Proposal, pp38-39.

benchmark.[164] For example, ETSA Utilities' actual net capex for the two regulatory periods to 30 June 2010 was $150.7 million less than originally forecast (real $2010). Similarly, Powercor Australia's actual net capex for the 2001-05 and 2006-10 regulatory periods was $281.4 million less than originally forecast and CitiPower's actual net capex was $201.7 million less than originally forecast (real $2010). CitiPower's forecast actual and determined capex forecast for the 2001-05 and 2006-10 regulatory periods is shown by way of example in Figure 1 below.

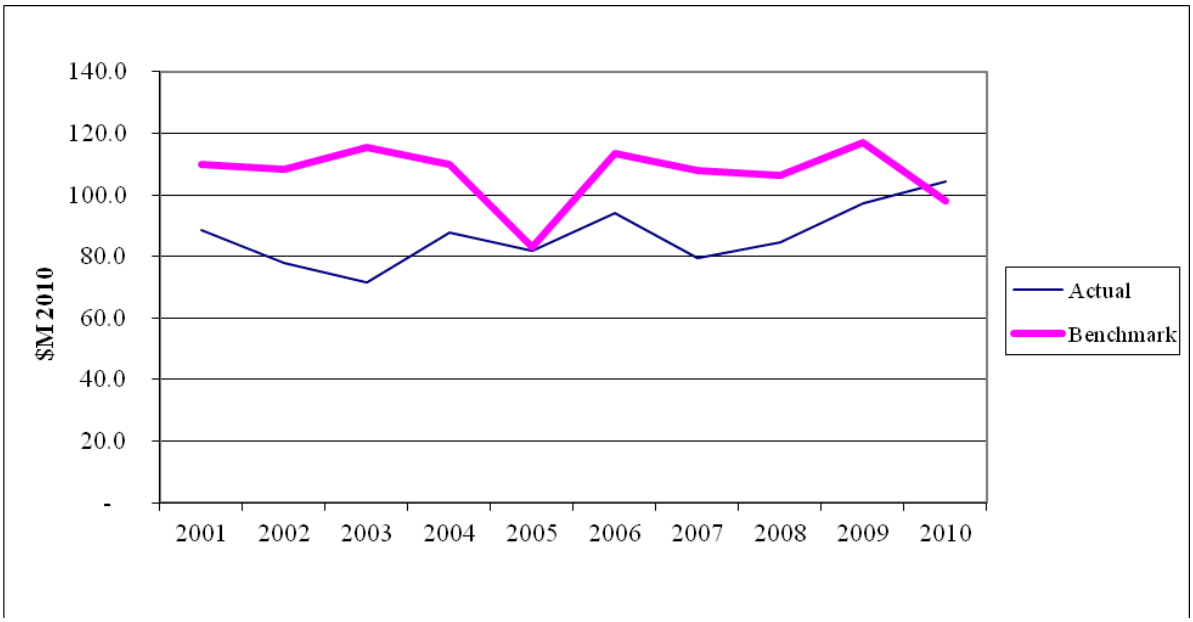

Figure 1 - CitiPower's actual and determined capex forecast ($m 2010 real)

Regardless of these issues, however, the Businesses note that the capex incurred in the regulatory periods referred to by the AER is irrelevant in the context of an assessment of the incentives under the Rules. Both the New South Wales and Queensland determinations referred to by the AER were made before the AER assumed responsibility for the regulation of DNSPs and before the Rules applied. If any actual capex versus forecast capex assessment is relevant, it would be the actual capex versus forecast capex in the most recent round of distribution determinations conducted by the AER under Chapter 6 of the Rules. This exercise is not presently possible given that the first DNSPs in respect of which the AER made a determination under the Rules are those in New South Wales, and those DNSPs are only half way through their regulatory control period.[165] It would be premature to form any view as to the effectiveness or otherwise of the current capex incentives based actual versus forecast capex on only two years of data from one jurisdiction.

The Businesses also observe that the AER has not shown that the NSPs' true WACC is lower than their regulated WACC, such that the circumstances in respect of which the AER raised specific concern apply in practice. Further, while the AER indicated the possibility of NSPs being influenced by incentives other than financial incentives, it is not clear on the basis of the AER Rule Change Proposal how the AER considers its Rule change addresses this.

The Businesses do not consider that the AER's proposed Rule change is necessary because the AER already has the power under the existing Rules to increase the incentives on NSPs to achieve

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[164] This was recognised by the AER in its draft decisions regarding these DNSPs: Victorian Distribution Determinations Draft Decision, p291; South Australian Distribution Determinations Draft Decision, p102.

[165] This current regulatory control period for New South Wales DNSPs is 1 July 2009 to 30 June 2014.

efficiency gains in respect of capex. Specifically, the Rules provide for the EBSS to be developed to cover efficiency gains and losses related to capex, in addition to efficiency gains and losses related to opex.[166] Rather than extending the EBSS to capex to improve the incentives on NSPs to increase efficiencies, however, the AER has proposed a change to the treatment of the RAB roll forward. In the absence of any reasons as to why the AER has done this, the Businesses can only assume that the AER is doing so to avoid the application of the mandatory considerations governing the development of the EBSS set out in the Rules.[167]

One such mandatory consideration is that in developing the EBSS the AER must have regard to the desirability of both rewarding the DNSP for efficiency gains and penalising the DNSP for efficiency losses.[168] The AER's Rule change proposal offers no reward for a DNSP whose actual capex is below the benchmark established in the distribution determination. Accordingly, the AER's approach is contrary to the principles recognised by the AEMC and reflected in the Rules as promoting the NEO in respect of schemes to encourage efficient capex. The AER's proposed scheme is also inconsistent with the international experience it draws upon in support of its Rule Change Proposal. According to the AER, Ofgem now has a two year lagged rolling capex incentive scheme with 'symmetrical sharing factors'.[169]

Another mandatory consideration governing the development of the EBSS is the need to provide DNSPs with a continuous incentive, so far as is consistent with economic efficiency, to reduce capex.[170] Contrary to this consideration, as well as the AER's stated concern with the existing incentive regime, the AER's proposal does not provide for a continuous incentive to reduce capex. This can be seen in the tables below.

In the case of a DNSP expending more than the forecast amount, the AER's proposed scheme (assuming a 5 year asset life) would increase the DNSP's share of any overspend, but would not provide for a continuous incentive, with the DNSP's share of the overspend declining over the period:

5 year life	DNSP share of overspend	
	Current Rule	AER Proposed Rule
Overspend in year 1	82%	107%
Overspend in year 2	69%	97%
Overspend in year 3	52%	83%
Overspend in year 4	31%	65%
Overspend in year 5	5%	43%

Table 2 - DNSP share of capex overspend

[166] Clause 6.5.8(b) of the Rules.

[167] Clause 6.5.8(c) of the Rules.

[168] Clause 6.5.8(c)(3) of the Rules.

[169] AER Rule Change Proposal, p43.

[170] Clause 6.5.8(c)(2) of the Rules.

Similarly, in the case of underspend, the DNSP's share of underspend would also decline over the regulatory control period:

5 year life	DNSP share of underspend	
	Current Rule	AER Proposed Rule
Underspend in year 1	82%	82%
Underspend in year 2	69%	69%
Underspend in year 3	52%	52%
Underspend in year 4	31%	31%
Underspend in year 5	5%	5%

Table 3 - DNSP share of capex underspends

The AER's proposed Rule change is therefore inconsistent with the principles that have been accepted by the AEMC and the SCO as promoting the NEO in the context of efficiency benefit sharing schemes, and does not meet one of the AER's stated objectives.

The AER has indicated that it seeks to introduce incentives to ensure that only efficient investment is incurred. However, the AER's proposed Rule change actually introduces a disincentive to incur efficient expenditure by penalising NSPs for making efficient investment in the network where the actual level of efficient expenditure is higher than forecast.

Capex forecasts are necessarily determined subject to a degree of uncertainty. Under the current Rules, DNSPs are required to submit forecasts to the AER in their regulatory proposals 13 months before the end of the existing regulatory control period. Forecasting capex over such a lengthy period invariably involves assumptions with respect to customer growth and network utilisation and so on that change over that time. NSPs should not be penalised for failing to determine efficient expenditure up to six years in advance, where there are good reasons for that failure (e.g. unforeseen circumstances or events and dynamic changes in demand).

Similarly, NSPs should not be penalised for the regulator failing to accurately determine the efficient level of capex prior to the beginning of the regulatory control period. Capex benchmarks are, in the overwhelming majority of cases, determined by the regulator (rather than being the level proposed by the NSP). The AER's proposed Rule change exposes NSPs to significantly greater consequences as a result of regulatory error in determining capex.

While the AER contends that its associated proposed Rule change to introduce capex reopeners can manage the situation where efficient capex in excess of the benchmark needs to be incurred, this is not the case. The AER's proposed criteria for the circumstances in which the AER can revoke a determination limit capex reopeners to all but the most extreme circumstances. The Businesses' concerns with the AER's proposal regarding capex reopeners are discussed in more detail below.

The AER's proposed Rule change also does not take into account the trade-offs between opex and service standards and any capex incentive regime. Whereas the AER highlighted Ofgem's observations that the strength of incentives vary depending on the other elements of the regulatory

framework,[171] the AER has made no attempt to explain how its proposal will operate in light of the EBSS and the STPIS.

The AER's proposed Rule change (inappropriately) locks a capex incentive regime into the Rules. The desirability of incentive schemes that can vary over time is recognised in the existing provisions of the Rules. The Rules codify the object of nature of each of the other incentive schemes that can be created (i.e. the object and nature of each of the EBSS, STPIS and DMIS), but leave the detailed specification of those incentive schemes to guidelines prepared by the AER. The desirability of flexibility was also the very reason the AER has proposed to introduce a general power to permit it to propose other incentive schemes. The AER stated:[172]

> Regulatory best practice is continually evolving, including the development of innovative new incentive schemes. While the AER does not currently endorse any particular scheme, the current process to implement new schemes [being a Rule change process] is cumbersome.
>
> ... The AER considers that it is an overly costly process to incrementally develop the regulatory regime in order to keep pace with international best practice.

The significance of the interplay between incentive schemes is also recognised in the existing Rule provisions governing the development of the EBSS, STPIS and DMIS.[173] Locking a capex incentive regime into the Rules in the manner proposed by the AER would (subject to a Rule change) lock the AER into that regime and constrain its ability to vary other incentives schemes over time.

Capex reopeners and contingent projects

As noted above, the AER's proposal to move away from including all actual capex in the opening RAB creates a disincentive for DNSPs to incur efficient capex higher than forecast capex. The Businesses reject the AER's suggestion that the capex expenditure reopener and contingent project provisions ameliorate these disincentives.

First, the scope for capex reopeners to allow efficient capex in excess of forecast capex is extremely limited. This is because:

- the reopener provision addresses only one source of divergence between forecast and actual capex, being events that are reasonably beyond the control of the DNSP and 'could not have reasonably been foreseen at the time of the making of the distribution determination'.[174] The provision does not allow for events that were foreseen but the cost implications of which were not properly understood at the time of the determination (e.g. because there was higher than expected customer demand or demand growth); and
- the AER proposes to set the threshold for a capex reopener event at 5% of the opening RAB for the first year of the regulatory control period.[175] For DNSPs such as Powercor Australia and ETSA Utilities, this equates (in the current regulatory control period) to more than $121 million and $145 million respectively, or approximately 45% of their

[171] AER Rule Change Proposal, p43.

[172] AER Rule Change Proposal, p56.

[173] Clauses 6.5.8(c)(4), 6.6.2(b)(3)(iv), 6.6.3(b)(4) of the Rules.

[174] AER Draft Rules, p33 (proposed clause 6.6.4(a)(1)).

[175] AER Draft Rules, p33 (proposed clause 6.6.4(4)(i)).

capex allowance for the first year of the period. It is difficult to conceive of a single event affecting a distribution network that would result in capex of this magnitude.

The Businesses also observe that as the criteria that the AER has to be satisfied of before allowing a capex reopener are extremely wide ranging, the AER's proposed Rule change would likely impose a significant administrative burden on both the DNSP and the AER. For instance, the AER needs to be satisfied that the DNSP is not able to reduce capex in other areas to avoid the adverse consequences of the event without materially adversely affecting the reliability and security of the relevant distribution system. This would appear to require the DNSP to re-justify its entire capex program (and potential opex program to address any trade-off issues), which would require detailed supporting material on par with the supporting material required in a distribution determination process. Any application would run into several hundreds of pages, and require the involvement of experts, at considerable cost to the DNSP. Similarly, any AER decision would likely run to several hundred pages and impose significant cost on the AER.

In addition, the Businesses observe that the DNSP is provided with only 90 business days from the time of the date of the event to lodge an application.[176] While the AER has provided itself with an opportunity to extend the time limit for the making of its decision on the application within,[177] no such opportunity to extend the time limit for the making of the application has been proposed. This is inconsistent with the existing provisions in Chapter 6 for pass through applications.[178]

Equally, the contingent project provisions proposed by the AER would not ameliorate the disincentive to incur efficient capex under the AER's capex incentive model. Primarily, this is because the contingent project provision, while suitable in the transmission context, is not suitable in the context of distribution. As noted by the SCO at the time Chapter 6 was enacted (without a contingent project provision), whereas transmission networks are made up of a small number of large assets, distribution networks have a large number of smaller assets and require regular investments to facilitate new connections, system augmentation and asset replacement.[179] No contingent project provision was included for distribution because distribution capex is not (in the way transmission capex is) lumpy and strongly influenced by individual projects.[180]

Further, the contingent project provisions cannot be considered adequate to address the disincentive to incur efficient capex under the AER's proposal because:

- the contingent projects provision requires the trigger event to be specified in the distribution determination. As such, it can only deal with what is known at the time of the determination; and
- the proposed initial threshold of $10 million is too high in the context of distribution. Given the nature of distribution networks, few, if any projects, on a distribution network

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[176] AER Draft Rules, p33 (proposed clause 6.6.4(b)).

[177] AER Draft Rules, pp34-35 (proposed clause 6.6.4(h)).

[178] Clause 6.6.1(k).

[179] SCO, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution, Explanatory Material*, April 2007, p49 (Table 1).

[180] SCO, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution, Explanatory Material*, April 2007, p53.

would exceed this threshold. As noted by the AER, a contingent project trigger threshold of $10 million was initially adopted in the transmission context because it was consistent with the regulatory test threshold in force at the time.[181] Now adopting a threshold of $10 million for distribution is inconsistent with the current MCE Rule change proposal to apply a distribution regulatory investment test to capex in excess of $5 million.[182] The Businesses observe the AER's position in this regard is difficult to reconcile with its acceptance of the $5 million threshold proposed for the application of the regulatory investment test for distribution.[183]

Summary

The AER's proposal to allow DNSPs to include only 60% of the value of any capex incurred in excess of forecast capex in the RAB is contrary to the NEO and the RPPs as it has the potential to deter efficient investment in the network and fails to provide DNSPs with a reasonable opportunity to recover their efficient costs.

While the Businesses agree that there is scope to increase incentives to reduce capex, the Businesses observe that the existing Rule provisions provide for this through the extension of the EBSS to capex. The Businesses maintain that the criteria governing the development of the EBSS are those that would promote the NEO and the RPPs. The AER's proposal is inconsistent with the provisions governing the development of the EBSS (which provisions should be assumed to promote the NEO and the RPPs), including in particular as it does not both reward DNSPs for efficiency gains and penalise DNSPs for efficiency losses and does not provide DNSPs with a continuous incentive to reduce capex.

The Businesses also observe that it would be contrary to the NEO and the RPPs for a capex incentive mechanism (such as the 40% sharing ratio advocated by the AER) to be locked into Rule provisions. That this would be so inconsistent has been recognised in the existing provisions of the Rules governing the development of incentive schemes. High level and principled guidance is offered, rather than specific regimes that cannot evolve with best practice regulation.

While the AER suggests its capex reopener and contingent projects provisions ameliorate the risk of deterring efficient capex in excess of forecasts, this is not the case given the scope for these provisions to apply in a distribution context is extremely limited.

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[181] AER Rule Change Proposal, p48.

[182] MCE, *Distribution Network Planning and Expansion Framework Rule Change Request*, January 2011 (initiated 29 September 2011), proposed clause 5.6.5CB(a)(2).

[183] AER, *MCE rule change proposal - Distribution network planning and expansion framework, AER submission on AEMC consultation* paper, 24 November 2011, p6.

A.4 PASS THROUGH EVENTS

AER Rule Change Proposal

Current Rule provisions

Under Chapter 6 of the Rules, a DNSP may seek the approval of the AER to pass through positive amounts where there is a pass through event that materially increases the costs of providing direct control services.[184]

The term 'materially' in the context of Chapter 6 takes its ordinary meaning.[185] The Rules provide that the AER may publish guidelines as to its likely approach to determining materiality in the context of possible pass through events,[186] but no such guidelines have been published to date.

Chapter 6A of the Rules provide that TNSPs may seek the approval of the AER to pass through positive amounts where there is a pass through event that entails the TNSP incurring materially higher costs in providing prescribed transmission services than it would have incurred but for the event.[187] The transmission Rules differ from the distribution provisions in that the term 'materially' is defined in this context to include an increase in costs that exceeds 1% of the maximum allowed revenue for the TNSP for that regulatory year.[188] (One exception to this materiality threshold is the cost pass through of network support payments. These cost pass throughs are not subject to any materiality threshold.[189])

In deciding whether positive amounts can be passed through, the AER must take into account, among other things:[190]

> the efficiency of the provider's decisions and actions in relation to the risk of the *positive change event*, including whether the provider has failed to take any action that could reasonably be taken to reduce the magnitude of the *eligible pass through amount* in respect of that *positive change event* and whether the provider has taken or omitted to take any action where such action or omission has increased the magnitude of the amount in respect of the *positive change event*[.]

AER's characterisation of 'the problem'

The AER raised a concern that the absence of a materiality threshold in Chapter 6 creates uncertainty for stakeholders and leads to increased administration costs for the AER to determine what constitutes a material event.[191] The AER also submitted that too much flexibility to adjust

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[184] Clause 6.6.1 of the Rules and the definitions of 'positive change event' and 'negative change event' in Chapter 10.

[185] Definition of 'material' in Chapter 10 of the Rules.

[186] Clause 6.2.8(4) of the Rules.

[187] Clause 6A.7.3 of the Rules and the definitions of 'positive change event' and 'negative change event' in Chapter 10.

[188] Definition of 'materially' in Chapter 10 of the Rules.

[189] Clause 6A.7.2 of the Rules.

[190] Clauses 6.6.1(j)(3) and clause 6A.7.3(j)(3) of the Rules.

[191] AER Rule Change Proposal, pp49, 52.

regulatory decisions may create an incentive for NSPs to 'devote resources to continually seeking upward adjustments to their forecasts rather than to beating their targets'.[192]

AER's proposed Rule changes

The AER proposed to introduce a 1% materiality threshold for DNSP pass through events, whereby a positive pass through event would only be considered material where the increase in costs exceeds 1% of the annual revenue requirement for the DNSP for that regulatory year.[193]

The AER stated that such a threshold 'provides an appropriate balance between providing certainty for distribution networks and maintaining incentives on those networks to operate efficiently'.[194] It indicated it would also bring DNSPs into line with TNSPs.[195]

Businesses' Response

Introduction

The Businesses are generally supportive of a Rule change to provide greater certainty for stakeholders on the materiality threshold for the pass through regime in Chapter 6, and agree that a materiality threshold enshrined in the Rules would reduce the administrative costs associated with determining what such a materiality threshold should be.[196]

The Businesses do not agree with the AER, however, that a materiality threshold is necessary to maintain the incentives on an NSP to operate efficiently.

The Businesses also reject the AER's proposed 1% materiality threshold on the basis that:

- transmission and distribution networks differ such that the same 1% materiality threshold should not be applied to both networks; and
- a materiality threshold of 1% of the annual revenue requirement is overly onerous and would frustrate the intent of the pass through regime in the distribution context.

The Businesses instead propose a materiality threshold enshrined in the Rules of $1 million for each pass through event.

A materiality threshold is not required to maintain incentives to improve efficiency

While the AER suggests that a materiality threshold is required to maintain incentives to improve efficiencies, this is inconsistent with two significant factors.

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[192] AER Rule Change Proposal, p49.

[193] AER Draft Rules, pp144-145 (proposed definitions of 'materially', 'negative change event' and 'positive change event').

[194] AER Rule Change Proposal, p52.

[195] AER Rule Change Proposal, p52.

[196] This includes the development of any guidelines as to the AER's likely approach to determining materiality in the context of possible pass through events pursuant to clause 6.2.8(a)(4) of the Rules and responding to stakeholder submissions on materiality during the distribution determination review process (including at the F&A Paper, draft determination and final determination stages).

First, the pass through regime is intended to provide NSPs with an opportunity to recover costs that are unexpected and outside of its control.[197] NSPs cannot seek to reduce expenditure where that expenditure is, by its nature, unexpected and beyond their control. Indeed, to the contrary, if a 1% materiality threshold was imposed on DNSPs, it would impact on the operation of the EBSS designed to encourage DNSPs to achieve efficiencies. This is because such a threshold changes the way in which efficiencies will be shared between customers and DNSPs. DNSPs will carry the risk of incurring significant additional costs each year (up to 1% of the annual revenue requirement for any one event, and more than 1% of the revenue requirement if more than one such event occurs), which will result in penalties under the EBSS. Previously, costs would have been treated as pass throughs and therefore not included in the EBSS calculation. Requiring DNSPs to absorb such costs represents a fundamental shift in the sharing ratio that underpins the EBSS because the ability for DNSPs to make efficiency gains would become proportionally harder.

Secondly, even if it is assumed that DNSPs could reduce the costs associated with pass through events, the AER's comments cannot be reconciled with the fact that the AER is required, in making a cost pass through determination, to take into account the efficiency of the DNSP's decisions and actions in relation to the risk of the cost pass through event, including whether the DNSP has failed to take any action that could reasonably be taken to mitigate the associated costs.[198] Any failure by the DNSP to move to mitigate its losses would no doubt impact on the level of costs that the AER determines can be passed through by the DNSP.

Differences between transmission and distribution justify different materiality thresholds

While advocating the alignment of the pass through provisions across distribution and transmission networks, the AER has not put forward any evidence to demonstrate that transmission and distribution networks are similar such that the same approach to materiality should be adopted. The Businesses submit there are significant differences between the two kinds of networks that suggest a different approach to assessing materiality for the purposes of pass through events is appropriate.

In particular, the Businesses observe that transmission capex is relatively lumpier and more strongly influenced by individual projects than distribution capex. This was recognised by the SCO in deciding not to establish capex reopeners in distribution (as exist in transmission). Clause 6A.7.1 of the Rules enables TNSPs to reopen revenue caps and pass through costs to customers where the capital costs of an event is beyond the reasonable control of the provider. This is subject to a materiality threshold that the total capex required during the regulatory control period to rectify the consequences of the event exceeds 5% of the RAB for the TNSP for the first year of the regulatory control period. The explanatory material for Chapter 6 of the Rules noted that this provision was not appropriate for DNSPs because high magnitude events that would likely trigger the reopener provision for TNSPs would be unlikely to occur in a distribution network.[199] This shows that the likely cost impact on distribution networks from any one event is likely to be smaller than on transmission networks, and thus the same materiality threshold should not be applied.

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[197] 2006 TNSP Rule Determination, p104.

[198] Clause 6.6.1(j)(3) of the Rules.

[199] SCO, *Changes to the National Electricity Rules to establish a national framework for the economic regulation of electricity distribution, Explanatory material*, April 2007, pp53-4.

1% of annual revenue requirement materiality threshold is onerous and would frustrate the intent of the pass through regime in the distribution context

As noted above, the intent of the pass through regime is to provide NSPs with an opportunity to recover costs that were unexpected and outside of its control.[200]

The AER's proposal to introduce a materiality threshold of 1% of a DNSP's annual revenue requirement represents a significant increase in the existing materiality threshold in the current Rules (which is, that the impact on cost must be 'material' in the ordinary sense of the word). This has the effect of significantly increasing the risk to DNSPs associated with unforeseen events, contrary to the intent of the pass through regime. If such a change were effected, DNSPs would require compensation for the increase in risk in regulated revenues (for instance, through self insurance provisions). The need for additional compensation in the case of such increased risk was recognised by the AEMC in its 2006 TNSP Rule Change Determination.[201] It appears unlikely, however, that the AER would offer any such compensation, the AER having rejected the submissions of Victorian DNSPs to this effect in the context of its proposed introduction of a 1% of smoothed forecast revenue materiality threshold in respect of nominated pass through events.[202]

The Businesses observe that a 1% of annual regulated revenue threshold would be particularly onerous given the AER's approach to delineating 'regulatory change events'. In the context of considering Powercor Australia's cost pass through application in relation to the implementation of the recommendations of the VBRC,[203] the AER concluded that the various actions taken to give effect to the recommendations of the VBRC would constitute separate pass through events.[204] The AER's approach has the effect of reducing the number of events that will be eligible to be passed through by NSPs. While the cumulative impact of a significant shift in the circumstances facing a DNSP (such as the giving effect to of the findings of the government inquiry) may be significant, any pass through of the associated costs may be prevented because the consequential legislative and administrative actions, when each action is considered individually, do not meet the materiality threshold.

The AER's proposed materiality threshold also compounds the issue of reduced scope for DNSPs to recover their efficient costs in respect of unforeseen events. There is an asymmetry in the relative frequency of positive versus negative pass through events, with most events being positive (i.e. resulting in DNSPs incurring increased costs). This is because, over time, the regulation of DNSPs becomes, on balance, increasingly onerous. This asymmetry results in systematic under-recovery by the DNSPs of uncontrollable costs. A 1% threshold on pass through events will compound this, which over the longer term (unless addressed through increased revenue allowances) may undermine the viability of the DNSP and its capacity to invest, and thus its ability to maintain security and safety of the network.

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[200] 2006 TNSP Rule Determination, p104.

[201] 2006 TNSP Rule Determination , p104.

[202] Victorian Distribution Determinations Final Decision, pp772-3.

[203] Powercor Australia, *Pass through application: Interim action in response to 2009 Victorian Bushfire Royal Commission,* 24 February 2011 (public version).

[204] AER, *Decision, Powercor, Cost pass through application in relation to the Victorian Bushfire Royal Commission,* May 2011, pp9-10.

The AER's proposed rule change would also introduce an asymmetry whereby a pass through event affecting all DNSPs (with similar cost implications for each), could only be recovered by some DNSPs (by reason of their relative revenue bases).

Alternative Rule change proposal

Rather than a materiality threshold of 1% of annual regulated revenue, the Businesses consider a materiality threshold of $1 million in a regulatory year should be imposed. The specification of a dollar amount in the Rules addresses the AER's stated concern of uncertainty and administrative cost associated with determining what is 'material'.

By imposing a materiality threshold that is more appropriate for distribution networks, the Businesses' proposal is more consistent with the object of the pass through regime of ensuring that DNSPs have a reasonable opportunity to recover unforeseen costs. As it does not vary with the revenue base, the Businesses' proposal also ensures that pass through events with a similar cost impact on DNSPs will be treated uniformly across all DNSPs.

The Businesses proposed drafting amendments to give effect to their proposal in the definition of materially in Chapter 10 of the Rules are set out below.

Summary

The AER's proposed introduction of a materiality threshold of 1% of a DNSP's annual revenue requirement for all pass through applications is contrary to the NEO and the RPPs.

The RPPs provide that NSPs should be provided with a reasonable opportunity recover their efficient and prudent costs, regardless of whether the costs were foreseeable or not. The materiality threshold proposed by the AER is overly onerous, significantly increasing the risk to DNSPs of costs associated with unanticipated events, which (unless provided for in their regulated revenues) is contrary to the intent of the pass through regime and the RPPs and puts the quality, safety and reliability of supply at risk, contrary to the NEO.

The Businesses submit that a materiality threshold of $1 million would increase the certainty for stakeholders around what is a material event for the purposes of the pass through provisions, and would alleviate the need for the AER to form a view as to what is material in specific instances, meeting the AER's stated concerns with the existing Rule provisions. Such a threshold would also avoid the adverse cost recovery consequences of the AER's proposed threshold, thereby promoting the NEO and the RPPs.

materially

For the purposes of:

(a) the application of clause 6A.7.3, an event (other than a network support event) results in a Transmission Network Service Provider incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the Transmission Network Service Provider has incurred and is likely to incur in any *regulatory year* of the *regulatory control period*, as a result of that event, exceeds 1% of the *maximum allowed revenue* for the *Transmission Network Service Provider* for that *regulatory year*.; or

(b) the application of clause 6.6.1, an event results in a *Distribution Network Service Provider* incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the *Distribution Network Service Provider* has incurred and is likely to incur in any *regulatory year* of the *regulatory control period*, as a result of that event, exceeds $1 million 1% of the *annual revenue requirement* for the *Distribution Network Service Provider* for that *regulatory year*.

In other contexts, the word has its ordinary meaning.

A.5 EXCLUDING RELATED PARTY MARGINS

AER Rule Change Proposal

Current Rule provisions

Under the current Rule provisions, the previous value of a DNSP's RAB must be increased by the amount of all capex incurred during the previous control period.[205]

AER's characterisation of 'the problem'

The AER identified what it considers to be an inconsistency within the existing Rules whereby margins paid by a DNSP to a related party:[206]

- can be excluded from forecast capex for the purposes of the building block determination where they do not reasonably reflect efficient costs; but
- must nonetheless be rolled into the RAB as they form part of the capex incurred during the previous regulatory control period.

The AER raised concerns that this presents an opportunity for DNSPs to benefit where the amount paid to the related party (and thus the amount rolled into the RAB) does not reflect the actual level of capex required.[207]

The AER also identified what it considers to be an incentive for DNSPs to change their approach to capitalising overheads during a regulatory control period.[208] The AER considered such an incentive exists because DNSPs would be permitted to recover the amounts through opex included in the annual revenue requirements under the distribution determination, and then also achieve a return on the amounts in the following regulatory control period by changing their capitalisation policy and rolling the amounts into the RAB as capitalised overheads.[209]

AER's proposed Rule changes

The AER's proposed Rule change provides that any 'related party margins' and 'capitalised overheads' included in the RAB must not exceed 'the amounts determined in accordance with how *related party margins* and capitalised *overheads* were included in the total forecast capital expenditure determined in the distribution determination for the previous control period'.[210]

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[205] Clause S6.2.1(e)(1) of the Rules.

[206] AER Draft Rule Change Proposal, pp53-4.

[207] AER Draft Rule Change Proposal, p54.

[208] AER Draft Rule Change Proposal, p54.

[209] AER Draft Rule Change Proposal, p54.

[210] AER Draft Rules, pp59-60 (proposed clause S6.2.1(e)).

Businesses' Response

Introduction

The Businesses acknowledge the AER's concern that under the current Rules there may be scope for actual capex incurred in a regulatory period to include related party margins that are not efficient, and accept a change in the Rules may be desirable. The Businesses are concerned, however, that the AER's proposed Rule changes are ambiguous and accordingly lack the certainty necessary to encourage efficient investment in electricity networks.

The Businesses submit that any Rule change should clarify that:

- related party margins can be included in the RAB where they would be considered efficient under the AER's framework for determining whether such margins are efficient in the previous distribution determination; and
- capitalised overheads can be included in the RAB where they are allocated consistently with the capitalisation policy in place at the time of the AER's previous distribution determination.

AER's proposed Rule change is ambiguous

The AER's proposed Rule change provides that any amounts of related party margins and capitalised overheads 'must not exceed the amounts determined in accordance with how *related party margins* and capitalised *overheads* were included in the total of the forecast capital expenditure determined in the distribution determination for the previous control period'.

The Businesses are concerned that the proposed Rule change may unreasonably limit the expenditure incurred that may be rolled into the RAB. In particular, it is not clear from the drafting whether the amount that can be included in the RAB is:

- the actual amount as determined in the distribution determination; or
- an amount that is determined by reference to the framework used to assess, or policies underpinning, the forecast amounts at the distribution determination stage, which amount may be higher or lower than the amounts approved at the distribution determination stage, depending on circumstances arising after the determination was made.

For the reasons outlined below, the Businesses submit that the former approach is inconsistent with the NEO, whereas the latter approach would promote the NEO and the RPPs. The Businesses therefore submit that amendments to the AER Draft Rules are required in order to ensure that any ambiguity is removed.

Rules should not be tied to the 'amounts' in the distribution determination

An approach to the RAB roll forward that permits only an amount up to the amount set out in the distribution determination to be included in the RAB would be impractical and inflexible, would curtail efficient investment in electricity networks and would subject NSPs to increased regulatory risk.

Such an approach assumes that the circumstances of the DNSP remain constant over time. Given a DNSP is required to submit its forecast capex and opex requirements 13 months prior to the end of the regulatory control period, this assumption is inappropriate.

Taking related party margins first, over the six years after the DNSP submits its regulatory proposal, the proportion and value of related party contracts are likely to change, rendering any assumption made for the purposes of the distribution determination invalid. For example, CitiPower is presently renegotiating its contract arrangements with CHED Services (an entity that falls within the definition of a 'related party'). The term of that agreement is likely to be three years with the option of extending that arrangement for a further two years. Whether CitiPower chooses to engage CHED Services, whether it extends the contract for a further two years and what the value of any margins CHED Services may earn in any further agreement is unlikely to be known with any certainty at the time of the next distribution determination. If DNSPs were limited to rolling into the RAB only those amounts set out in the distribution determination, CitiPower would be prevented from receiving a return on any margins paid to CHED Services in addition to the amounts set out in the distribution determination, regardless of whether or not they are efficient. Similarly, a scenario can readily be imagined in which a DNSP may have no related party contracts (and hence have no provision in its allowed capex for related party margins) at the commencement of a regulatory review but enter into such a contract during the course of the regulatory control period. That DNSP would, under such an approach, have any margins paid under the contract automatically disallowed, irrespective of whether the contract is a more efficient arrangement.

A similar issue exists with capitalised overheads. The actual allocation of overheads between capex and opex is a product of the ratio of the two. For example, Powercor Australia allocates overheads via an overhead rate which is calculated as the forecast overhead pool divided by the relevant forecast cost base.[211] Accordingly, the amount of capitalised overhead depends on the forecasts of:

- each of the overhead pool costs;
- each cost base that applies to each overhead pool;
- relative opex and capex (including those step changes which attract overheads); and
- relative costs of standard control, alternative control, negotiated, metering and unregulated services.

Powercor Australia may be required to undertake proportionally more capex to opex than originally forecast due to a change in circumstance driven by demand, technology etc. Under its existing capitalisation policies, this would result in capex attracting a proportionately greater share of overheads purely as a result of expenditure mix. If the RAB roll forward was tied to the capitalised overhead amounts set out in the distribution determination, this additional capex would be excluded from the RAB. The expenditure allowances in a distribution determination will almost certainly never reflect actual portions of capex to opex incurred. Thus, a Rule change that seeks to 'fix' an amount of overheads will most likely result in DNSPs being unfairly penalised as a result of changes in the expenditure mix or, in the worst case, result in a DNSP adopting a less efficient opex solution in preference to capex to avert the stranding of legitimately and efficiently incurred overhead costs.

As well as failing to account for changing circumstances over time, allowing only amounts up to the related party margin and capitalised overheads amounts set out in the distribution determination to be rolled into the RAB would result in the DNSP being subject to increased regulatory risk. In the event the AER underestimated the level of efficient expenditure required or underestimated the level of capex required relative to opex in making its determination, the DNSP would be penalised. The Businesses do not believe DNSPs should be penalised for errors made by the AER.

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[211] Powercor Australia Revised Regulatory Proposal, p172.

Alternative Rule change proposal

The Businesses believe that if a Rule change is considered necessary, the Rules regarding related party margins should incorporate an assessment of the capex incurred by reference to the framework for assessing related party margins in the previous distribution determination. This is a more flexible approach, which allows for changing market and business conditions and requires the AER to properly consider the prudency and efficiency of any related party margin incurred. By requiring the assessment to be undertaken by reference to the methodology outlined in the previous distribution determination, the Businesses' proposed Rule change would give the NSPs greater certainty as to whether the capex incurred will be included in the RAB.

Similarly, any new Rules regarding the inclusion of capitalised overheads in the RAB should incorporate an assessment of the capitalised overheads by reference to the capitalisation policy in place at the time of the distribution determination. Before refusing to roll any capitalised overhead amounts into the RAB, the AER should be required to demonstrate that the overhead was allocated to capex inconsistently with the capitalisation policy used in determining the capex allowances in the previous distribution determination.

The Businesses set out possible amendments to the AER Draft Rules below (clause S6.2.1(e)(1)).

Summary

The AER's proposed Rule change is ambiguous as to whether it seeks to limit the related party margins and capitalised overheads that can be rolled into the RAB to the amounts specified in the draft determination (as opposed to limiting the amounts to the amounts determined by reference to the framework for assessing related party margins set out in the previous distribution determination and the capitalisation policy underpinning that determination).

The Businesses consider that such a limitation is inconsistent with the NEO and the RPPs as it potentially strands efficiently incurred costs. It does this by ignoring the dynamic nature of business and market conditions that mean the expenditure allowances established in the distribution determination are rarely, if ever, met. As a result, such an approach would deter efficient capex, and potentially encourage inefficient opex at the expense of more efficient capex solutions.

If the AEMC considers that a Rule change is desirable, the Businesses submit that the Rules should provide for related party margins to be rolled into the RAB provided they are consistent with the framework established in the prior distribution determination. Similarly, decisions as to the inclusion of overheads in the RAB roll forward should be based on whether they were allocated to capex consistently with the capitalisation policy of the DNSP at the time of the distribution determination.

S6.2.1 Establishment of opening regulatory asset base for a regulatory control period

...

(e) **Method of adjustment of value of regulatory asset base**

Except as otherwise provided in paragraph (c) or (d), the value of the regulatory asset base for a *distribution system* as at the beginning of the first *regulatory year* of a *regulatory control period* must be calculated by adjusting the value (the **previous value**) of the regulatory asset base for that *distribution system* as at the beginning of the first *regulatory year* of the immediately preceding *regulatory control period* (the **previous control period**) as follows:

...

Any amounts of *related party margins* ~~and capitalised *overheads* included in the total capital expenditure must not exceed the amounts determined in accordance with how *related party margins* and capitalised *overheads*~~ may be excluded from the regulatory asset base if, following the application of the framework for assessing *related party margins* for the purposes of the building block ~~were included in the total of the forecast capital expenditure determined in the distribution~~ determination for the previous control period, the amount does not reasonably reflect the *capital expenditure criteria*.

Any amounts of capitalised *overheads* may be excluded from the regulatory asset base if the amount was not allocated as capital expenditure consistently with the *Distribution Network Service Provider's* capitalisation policy on the basis of which the building block determination for the previous control period was made.

Note:

The total of the forecast capital expenditure determined in a distribution determination may be subject to clauses 6.6.4(f) and 6.6A.2(e)(3).

A.6 OTHER INCENTIVE SCHEMES

AER Rule Change Proposal

Current Rule provisions

Under the current Rules, the AER is required to publish the following incentive schemes:

- EBSS, to provide for a fair sharing between the DNSP and the distribution network users of the efficiency gains or losses derived from actual opex being less than or more than the forecast opex accepted or substituted by the AER;[212]
- STPIS, to provide incentives for DNSPs to maintain and improve reliability performance;[213] and
- DMIS, to provide incentives for DNSPs to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.[214]

In making a distribution determination, the AER is then required to make a decision on how any applicable EBSS, STPIS or DMIS is to apply to the DNSP.[215]

AER's characterisation of 'the problem'

The AER believes that it is restricted from adopting incentive schemes consistent with regulatory best practice as, under the current Rules, it is unable to introduce a new incentive scheme without initiating a full Rule change process.[216] It considers this is problematic due to the costs it imposes on stakeholders and because incentive schemes generally develop incrementally over time.[217]

The AER does not, at the present time, endorse any particular new incentive scheme.[218]

AER's proposed Rule changes

The AER proposed a Rule change that would provide it discretion to create new incentive schemes to apply to DNSPs where 'the AER considers that there are benefits to end users or customers arising from applying the incentive scheme or schemes to [DNSPs]'.[219] The AER's Rule change proposal contemplates that, at the same time as publishing the incentive scheme, the AER will publish 'if

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[212] Clause 6.5.8(a) of the Rules.

[213] Clause 6.6.2(a) of the Rules.

[214] Clause 6.6.3(a) of the Rules.

[215] Clause 6.12.1(9) of the Rules.

[216] AER Rule Change Proposal, p56.

[217] AER Rule Change Proposal, p56.

[218] AER Rule Change Proposal, p56.

[219] AER Draft Rules, p35 (proposed clause 6.6.5(a)).

applicable, any parameters for the scheme' and 'any requirements with which the values attributed to the parameters ... must comply'.[220]

In developing a new incentive scheme, the AER would be required to follow the 'distribution consultation procedures' outlined in the Rules[221] and would be required to have regard to:[222]

- the possible effects of the incentive scheme on incentives for DNSPs to implement non-network alternatives;
- the need to ensure that the incentives are sufficient to offset any financial incentives the DNSP may have to reduce costs at the expense of service levels;
- the need to ensure that benefits to consumers likely to result from the incentive scheme are sufficient to warrant any reward or penalty under the incentive scheme for DNSPs;
- the willingness of the customer or end user to pay for improved performance in the delivery of services; and
- any other incentives available to the DNSP under the Rules or under a relevant distribution determination.

The AER also proposed Rules to allow for the incentive schemes and parameters to be amended or replaced from time to time (including when these would apply),[223] and a consequential amendment to include a decision on how any other incentive scheme will apply in the list of the AER's constituent decisions at the distribution determination stage.[224]

Businesses' Response

Introduction

The Businesses are strong supporters of incentive based regulation and are not opposed to the introduction of further incentive schemes if appropriately designed.

The Businesses do not address in this Response whether the AER should be given a general discretion to introduce new incentive schemes. However, in the event the AEMC is minded to introduce such a discretion, the Businesses observe that the AER's proposed Rule changes would not promote the NEO or the RPPs as they do not offer sufficient certainty or clarity. The Businesses consider that additional criteria governing the AER's discretion should be enshrined in any Rule provision that is enacted.

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[220] AER Draft Rules, p35 (proposed clauses 6.6.5(c)-(d)).

[221] AER Draft Rules, p35 (proposed clause 6.6.5(a)).

[222] AER Draft Rules, p35 (proposed clause 6.6.5(b)).

[223] AER Draft Rules, pp35-6 (proposed clauses 6.6.5(e)-(g)).

[224] AER Draft Rules, pp49-50 (proposed clause 6.12.1(9)).

Criteria governing the AER's exercise of discretion

In making the current Rules, policy makers formed a view as to the level of prescription in the Rules and the level of discretion afforded to the AER that would promote the NEO. A deliberate decision was made to:

- codify in the Rules the:
    - object and nature of each of the incentive schemes that could be created by the AER (i.e. the object and nature of each the EBSS, STPIS and DMIS); and
    - specific criteria that had to be applied in creating those schemes; but
- leave the detailed specification of those incentive schemes to guidelines prepared by the AER.

The AER's proposed Rule changes shift the balance that was originally struck by the AEMC and transfer additional powers from the AEMC to the AER. Thus, if the AEMC concludes that the AER should be given the power to introduce new incentive schemes, the AEMC should supplement the AER's proposed decision-making criteria to ensure greater clarity, transparency and predictability in the regulatory framework in order to mitigate the potential for adverse impacts on investment.

Most significantly, the Businesses consider that the Rules should require any incentive scheme to be symmetric in nature, that is, to provide both rewards and penalties for performance under the scheme.

The importance of symmetry in incentive schemes has been considered, in particular, in the context of the EBSS. In considering the EBSS provisions (at that time in the context of transmission), the AEMC stated:[225]

> The efficiency benefit-sharing mechanism for operational expenditure aims to provide continuous incentive for TNSPs to make operating expenditure savings in each year of a regulatory period. The Commission considers that providing anything other than a rule framework which provides for the symmetric treatment of expenditure efficiency gains and losses would prevent the incentive mechanisms from achieving its objective of providing even incentives in each year.

The object of symmetry was also accepted by the SCO in the distribution context in which the SCO accepted the AER's suggestion that efficiency benefit sharing schemes should apply to both efficiency gains and losses and stated that '[s]ymmetrical incentives are important in the regulatory design and are consistent with the AEMC's approach in electricity transmission'.[226]

In the absence of a clear requirement in the Rules to ensure that any new incentive scheme is symmetric, the AER may develop incentives schemes that are not symmetric and thus do not promote the NEO and the RPPs. The AER has demonstrated its capacity to disregard the importance of symmetry in incentive schemes in its (asymmetric) capital expenditure incentive scheme, proposed elsewhere in its Rule Change Proposal. For the reasons outlined in section 3.3 and section A.3 of Annexure A, such a scheme does not promote the NEO and the RPPs.

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[225] 2006 TNSP Rule Determination, p96.

[226] SCO, *SCO Response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, accompanying SCO's *Energy Market Reform Bulletin No. 95* dated 1 August 2007, p22.

Further, the Businesses consider that the AER should also be required to have regard to the following:

- the desirability of incentive schemes that are simple to administer. Schemes that are administratively difficult to implement or interpret are likely to result in the management of NSPs ignoring the scheme, thereby reducing the impact the incentive scheme will have on actual outcomes;

- the desirability of ensuring that financial or non-financial targets set by the scheme do not put the safe and reliable operation of the network at risk. While the AER identified this as one of the matters the AER must have regard to in its Rule Change Proposal,[227] this was not reflected in the AER Draft Rules;[228] and

- any regulatory obligation or requirement to which the DNSP is subject.

The Businesses' proposed alternative drafting amendments are set out below (clauses 6.4.3(a) and (b) and 6.6.5). The Businesses observe that their proposed alternative drafting amendments to clause 6.4.3 of the Rules in respect of the treatment of shared assets are also set out below.

Summary

The Businesses do not oppose the introduction of new incentive schemes and are supportive of balanced, well reasoned incentive arrangements.

To the extent the AEMC determines that the AER should have discretion to implement other new incentive schemes without seeking a Rule change, the criteria proposed by the AER in assessing any potential new incentive scheme are inadequate and should be supplemented to improve clarity, transparency and predictability and thus promote the NEO and the RPPs.

[227] AER Rule Change Proposal, p57.

[228] AER Draft Rules, p35 (proposed clause 6.6.5(b)).

6.4.3 Building block approach

(a) **Building blocks generally**

The *annual revenue requirement* for a *Distribution Network Service Provider* for each *regulatory year* of a *regulatory control period* must be determined using a building block approach, under which the building blocks are:

(1) indexation of the regulatory asset base – see paragraph (b)(1); and

(2) a return on capital for that year – see paragraph (b)(2); and

(3) the depreciation for that year – see paragraph (b)(3); and

(4) the estimated cost of corporate income tax of the provider for that year – see paragraph (b)(4); and

(5) the revenue increments or decrements (if any) for that year arising from the application of the *efficiency benefit sharing scheme*, the *service target performance incentive scheme*, ~~and~~ the *demand management incentive scheme* and other incentive scheme or schemes ~~developed and *published* under clause 6.6.5~~ – see paragraph (b)(5); and

(6) the other revenue increments or decrements (if any) for that year arising from the application of a control mechanism in the previous *regulatory control period* – see paragraph (b)(6); and

(7) the forecast operating expenditure for that year – see paragraph (b)(7)~~.~~; and

(8) if applicable, any revenue decrement for that year arising from the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than ~~the provision of~~ *standard control services* - see paragraph (b)(8).

(b) **Details of the building blocks**

For the purposes of paragraph (a):

(1) for indexation of the regulatory asset base:

(i) the regulatory asset base is calculated in accordance with clause 6.5.1 and schedule 6.2; and

(ii) the building block comprises a negative adjustment equal to the amount referred to in clause S6.2.3(c)(4) for that year; and

(2) the return on capital is calculated in accordance with clause 6.5.2; and

~~**Note:**~~

~~*A statement of regulatory intent* may be relevant to the calculation (See clause~~

~~6.5.4).~~

(3) the depreciation is calculated in accordance with clause 6.5.5; and

(4) the estimated cost of corporate income tax is determined in accordance with clause 6.5.3; and

~~**Note:**~~

~~A *statement of regulatory intent* may be relevant to the calculation (See clause 6.5.4).~~

(5) the revenue increments or decrements referred to in paragraph (a)(5) are those that arise as a result of the operation of an applicable *efficiency benefit sharing scheme*, *service target performance incentive scheme*, or *demand management incentive scheme* or other incentive scheme or schemes as referred to in clauses 6.5.8, 6.6.2, ~~and~~ 6.6.3 and 6.6.5; and

(6) the other revenue increments or decrements referred to in paragraph (a)(6) are those that are to be carried forward to the current *regulatory control period* as a result of the application of a control mechanism in the previous *regulatory control period* and are apportioned to the relevant year under the distribution determination for the current *regulatory control period*; and

(7) the forecast operating expenditure for the year is the forecast operating expenditure as ~~accepted or substituted~~determined by the *AER* in accordance with clause 6.5.6~~.~~; and

(8) the decrement referred to in paragraph (a)(8) is any revenue decrement accepted or substituted by the *AER* in accordance with clause 6.5.7A.

…

6.6.5 Other incentive schemes

(a) The *AER* may, in accordance with the *distribution consultation procedures*, develop and *publish* an incentive scheme or schemes other than the *service target performance incentive scheme*, *demand management incentive scheme* and the *efficiency benefit sharing scheme* to apply to *Distribution Network Service Providers* ~~where the *AER* considers that there are benefits to end users or customers arising from applying the incentive scheme or schemes to *Distribution Network Service Providers*~~.

(b) In developing and implementing an incentive scheme or schemes under this clause, the *AER* must have regard to:

(1) the need to ensure any incentive scheme incorporates both rewards and penalties for *Distribution Network Service Providers*; and

(~~1~~2) the possible effects of the scheme or schemes on the incentives for *Distribution Network Service Providers* to implement non-network alternatives; and

(~~2~~3) the need to ensure that the incentives are sufficient to offset any financial incentives the *Distribution Network Service Provider* may have to reduce costs at the expense of service levels; and

(~~3~~4) the need to ensure that benefits to consumers likely to result from the incentive scheme or schemes are sufficient to warrant any reward or penalty under the incentive scheme or schemes for Distribution Network Service Providers; and

(~~4~~5) the willingness of the customer or end user to pay for improved performance in the delivery of services; and

(6) any *regulatory obligation or requirement* to which the *Distribution Network Service Provider* is subject; and

(7) the need to ensure that any financial or non-financial targets set by the scheme do not put the safe and reliable operation of the distribution network at risk; and

(8) the desirability of incentive schemes that are simple to administer; and

(~~5~~9) any other incentives available to the *Distribution Network Service Provider* under the *Rules* or under a relevant distribution determination.

(c) At the same time as it *publishes* an incentive scheme or schemes under this clause, the *AER* must also *publish*, if applicable, any parameters for the scheme. For the avoidance of doubt, the parameters may differ as between *Distribution Network Service Providers* and over time.

(d) The *AER* must set out in the incentive scheme or schemes that is developed and *published* under this clause any requirements with which the values attributed to the parameters referred to in paragraph (c) must comply.

(e) The *AER* may, from time to time and in accordance with the *distribution consultation procedures*, amend or replace any ~~other~~ incentive scheme or parameter ~~schemes~~ that is developed and *published* under this clause~~, except that no such amendment or replacement may change the application of the incentive scheme or schemes to a *Distribution Network Service Provider* in respect of a *regulatory control period* that has commenced before, or that will commence within 15 months of, the amendment or replacement coming into operation~~.

(f) ~~Subject to paragraph (g) the AER may, from time to time and in accordance with the distribution consultation procedures, amend or replace the values to be attributed to any parameters applicable to the incentive scheme or schemes.~~An amendment or replacement incentive scheme or parameter developed and *published* under paragraph (e) only becomes the applicable scheme or part of the applicable scheme for the purposes of 6.12.1(9) if it is published 15 months prior to the commencement of the relevant *regulatory control period*.

~~(g) An amendment or replacement referred to in paragraph (f) must not change the values to be attributed to any parameters applicable to the incentive~~

scheme or schemes where:

(1) those values must be included in information accompanying a *regulatory proposal*; and

(2) the *regulatory proposal* is required to be submitted under clause 6.8.2(a) at a time that is within 2 months of the *publication* of the amended or replaced parameters applicable to the incentive scheme or schemes.

A.7 TREATMENT OF SHARED ASSETS

AER Rule Change Proposal

Current Rule provisions

The current Rules provide for DNSPs to receive a return on and of their RAB, which is the value of the assets that are used by the DNSP to provide standard control services (only to the extent that they are used to provide such services).[229]

The Rules provide for the value of the RAB to be decreased where an asset that was previously used to provide standard control services, as a result of a change to the classification of a particular service, is not to be used for that purpose for the relevant regulatory control period.[230]

AER's characterisation of 'the problem'

While the Rules provide for assets that no longer provide standard control services to be removed from the RAB, the AER is concerned that users who effectively pay for assets used to deliver standard control services currently receive no compensation if DNSPs use these assets *in part* to deliver other services.[231]

AER's proposed Rule changes

The AER proposed changes to the Rules to give itself a discretion to introduce regulated revenue or control mechanism adjustments for situations where assets in the RAB are used to provide services other than standard control services. Specifically, the AER proposed:

- an additional building block constituting 'any revenue decrement for that year arising from the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than the provision of *standard control services*';[232]
- to include a requirement to address in the F&A Paper whether there is to be an adjustment for the use or forecast use of assets forming part of the RAB for the provision of services other than standard control services in the control mechanism or by an adjustment to the building blocks or a combination of these;[233] and
- to introduce, as a new constituent decision in the AER's distribution determination, a decision on whether there is to be an adjustment for the use or forecast use of assets forming part of the RAB for the provision of services other than standard control services in the control mechanism or by an adjustment to the building blocks or a combination of these.[234]

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[229] Clause 6.5.1(a) of the Rules.

[230] Clause S6.2.1(e)(7) of the Rules.

[231] AER Rule Change Proposal, p58.

[232] AER Draft Rules, p17 (proposed clause 6.4.3(a)(8)).

[233] AER Draft Rules, pp41-2 (proposed clause 6.8.1(b)(2)).

[234] AER Draft Rules, p50 (proposed clause 6.12.1(13A)).

The AER indicated that flexibility as to whether an adjustment through the building block determination or the control mechanism could be used was desirable because it cannot anticipate the circumstances it may face in future and should therefore have the ability to adopt the most appropriate approach based on the circumstances it encounters.[235]

Businesses' Response

The Businesses accept the principle that where the assets used to supply standard control services are shared between these and other services, gains to the NSP from non-standard control services should be shared with standard control services customers. However, the Businesses submit that, consistent with the MCE's policy decision to separate the functions of Rule making and Rule administration (with the functions going to the AEMC and the AER respectively),[236] the AER should not be given an unfettered discretion to introduce such adjustments; clear criteria should be enshrined in the Rules to govern the AER's discretion. Further, even where criteria governing the AER's discretion are introduced, appropriate measures should be put in place to maintain the transparency and predictability of the regulatory regime. Each of these matters are addressed in turn below.

As noted by the AEMC in its 2006 TNSP Rule Determination, while regulatory discretion allows economic regulation to adapt to the individual circumstances of regulated businesses across different periods of time, 'importantly, ... where legal rules confer discretions on regulators the rules should also specify criteria for exercising those discretions'.[237] This is important in the present context to ensure transparency and certainty and thereby encourage efficient use of the assets in the RAB (to reduce overall costs to standard control services customers).

For instance, any new provision adopted by the AEMC should explicitly state that any framework adopted by the AER is to provide for the fair sharing of the profits from the provision of services other than standard control services using assets forming part of the RAB between the DNSP and the users. Expressly identifying the object and nature of the scheme would be consistent with the approach adopted elsewhere in the Rules, for example, in the provisions governing the EBSS, STPIS and DMIS.[238]

It would also be consistent with the approach adopted in respect of the EBSS, STPIS and DMIS to set out mandatory criteria to be applied in the development of any framework.[239] The Businesses consider that the Rules should require the AER to have regard to:

- the need to maintain incentives for DNSPs to engage in unregulated activities that utilise shared standard control services assets. It is clear that where gains are shared, users of standard control services benefit from more efficient shared utilisation of network assets. Any proposal that creates a disincentive for DNSPs to engage in such activities, including activities in emerging areas, will not promote the NEO;

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[235] AER Rule Change Proposal, pp60-1.

[236] 2006 TNSP Rule Determination, p30.

[237] 2006 TNSP Rule Determination, pxx.

[238] Clauses 6.5.8(a), 6.6.2(a) and 6.6.3(a) of the Rules.

[239] Clauses 6.5.8(c), 6.6.2(b) and 6.6.3(b) of the Rules.

- the need to offer rewards to compensate for the relative risks borne by the DNSPs and users. The greater the risk borne by a party, the greater the share of the benefits that party should expect to receive;

- the need to ensure the benefits to users associated with any sharing of gains materially exceed the costs of regulatory oversight; and

- any other adjustment or control mechanism providing for the sharing of gains. It is the overall package of incentives that should be considered by the AER.

Even where criteria governing the AER's discretion are introduced, appropriate measures should be put in place to maintain the transparency and predictability of the regulatory regime. The AER's proposed Rule change provided for the AER to signal its approach to any adjustments relating to shared assets at the F&A Paper stage. Given the Businesses' proposed changes to the requirement to produce an F&A Paper discussed in section C.4 of Annexure C below (i.e. that the F&A Paper be required only in certain circumstances), amendments to the Businesses' proposed Rules are required to provide that one of the triggers for an F&A Paper is an intention to apply adjustments for the use or forecast use of assets forming part of the RAB for the provision of services other than standard control services.

The Businesses understand that the AER would, without any further changes to the Businesses' proposed Rules regarding the publication of the F&A Paper, be required to consult on any changes to control mechanisms to share the profits from services other than standard control services provided using assets in the RAB at the F&A Paper stage because any proposal to introduce such mechanisms would constitute a proposal to introduce control mechanisms that differ in a material respect from the control mechanisms in the current Distribution Determinations (which would in turn trigger an obligation to publish an F&A Paper under the Businesses' proposed clause 6.8.1, as set out in section C.4 of Annexure C below). To the extent the AEMC or AER takes a different view, the Businesses submit that an obligation to publish an F&A Paper setting out the AER's proposed approach should be made explicit in the Rules.

Finally, the Businesses observe that the AER's proposed Rule change did not impose any limits on the AER's discretion to adopt at the distribution determination stage an adjustment mechanism different to that set out in the F&A Paper. In the interests of regulatory certainty, and consistent with the AER's proposed approach in respect of the control mechanism, the Businesses submit that the AER should be required to calculate any adjustments in accordance with the framework set out in the F&A Paper, unless there are circumstances that were unforeseen at the time the AER published the relevant F&A Paper which justify a departure from that framework.

The Businesses' alternative proposed Rule changes are set out in section A.6 above, section C.4 of Annexure C below and in this section further below. By way of summary, the changes proposed include the following:

- amendments to add to the list of matters proposed in clause 6.8.1 that trigger a requirement on the AER to publish an F&A Paper (see the drafting amendments set out in section C.4 of Annexure C below). The Businesses propose that one of the triggers for the requirement to publish an F&A Paper should be notice that the AER or the DNSP considers an adjustment for the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than standard control services in the control mechanism or by an adjustment to the building blocks as referred to in clause 6.4.3(a)(8) or a combination of these adjustments may be required;

- a proposed new clause 6.5.7A to set out clear criteria to govern the making of a revenue decrement in the building block determination, and an analogous proposed new clause 6.5.7B to set out the same criteria to govern the AER's decision in the event the AER seeks to provide for profit sharing through the control mechanism (see the drafting amendments set out below); and

- a proposed new clause 6.12.3(d) to provide that any revenue decrement must be calculated in accordance with the framework set out in the F&A Paper unless there are circumstances that were unforeseen at the time the AER published the relevant F&A Paper which justify a departure from the framework specified in that paper or determination (see below).

Summary

The Businesses accept the principle that where the assets used to supply standard control services are shared between these and other services, gains to the NSP from non-standard control services should be shared with standard control services customers. However, the Businesses submit that the AER should not be provided with an unfettered discretion to introduce such adjustments; clear criteria should be enshrined in the Rules governing the AER's discretion to ensure transparency and certainty and thereby encourage efficient use of the assets (to reduce overall costs to standard control services customers), consistent with the NEO and the RPPs.

Further, even where criteria governing the AER's discretion are introduced, appropriate measures should be put in place to maintain the transparency and predictability of the regulatory regime. In this instance, the Businesses submit that the AER should be required to outline its proposed approach to any adjustment in its F&A Paper, and should be required to calculate any adjustment in accordance with the approach set out in the F&A Paper, unless there are circumstances that were unforeseen at the time the AER published the F&A Paper which justify a departure from the method set out in the Paper.

6.5.7A Revenue adjustments for assets used for services other than standard control services

(a) The *AER* may develop a framework to apply a revenue decrement to provide for a fair sharing between the *Distribution Network Service Provider* and *Distribution Network Users* of the profits achieved by the *Distribution Network Service Provider* from the provision of services other than *standard control services* using assets forming part of the regulatory assets base.

(b) In developing a framework under paragraph (a) and in deciding whether to apply a revenue decrement for a year the AER must have regard to:

(1) the need to maintain incentives for *Distribution Network Service Providers* to provide services other than *standard control services* using assets in the regulatory asset base so far as is consistent with economic efficiency; and

(2) the need to offer rewards to compensate for the relative risks borne by the *Distribution Network Services Provider* and *Distribution Network Users*; and

(3) the need to ensure that the benefits of the framework materially exceed the costs of regulatory oversight of the framework; and

(4) any other sharing of the profits achieved by the *Distribution Network Service Provider* from the provision of services other than *standard control services* provided for in the control mechanism.

6.5.7B Adjustments for assets used for services other than standard control services in the control mechanism

(a) To the extent the *AER* proposes to adjust for the use of assets forming part of the regulatory asset base provision of services other than *standard control services* in the control mechanism, the AER must:

(1) provide for a fair sharing between the *Distribution Network Service Provider* and *Distribution Network Users* of the profits achieved by the *Distribution Network Service Provider* from the provision of services other than *standard control services* using assets forming part of the regulatory assets base; and

(2) have regard to:

(i) the need to maintain incentives for *Distribution Network Service Providers* to provide services other than *standard control services* using assets in the regulatory asset base so far as is consistent with economic efficiency; and

(ii) the need to offer rewards to compensate for the relative risks borne by the *Distribution Network Service Providers* and *Distribution Network Users*; and

(iii) the need to ensure that the benefits of the framework

materially exceed the costs of regulatory oversight of the framework; and

(iv) any other sharing of profits achieved by the *Distribution Network Service Provider* from the provision of services other than *standard control services* provided for under a framework developed under clause 6.5.7A(a).

…

6.12.3 Extent of AER's discretion in making distribution determinations

…

(d) Any adjustment for the forecast use of assets forming part of the regulatory asset base for the provision of services other than *standard control services* must be calculated in accordance with the approach set out in the relevant *framework and approach paper* unless the *AER* considers that, in light of the *Distribution Network Service Provider's regulatory proposal* and the submissions received, there are circumstances that were unforeseen at the time the *AER published* the relevant *framework and approach paper* which justify a departure from the approach specified in that paper.

ANNEXURE B - DETERMINATION OF RATE OF RETURN

B.1 STATUS OF WACC REVIEWS IN DETERMINATIONS

AER Proposed Rule Changes

Current Rule provisions

Chapter 6A requires that the AER use any parameter values or methodologies, or credit rating levels, adopted by it in a WACC review conducted in accordance with that Chapter for the purposes of any revenue proposal submitted to the AER by a TNSP after the completion of the review.[240] There is no discretion for the AER to depart from a value, method or level adopted by it in a WACC review in making a transmission determination.

On the subsequent introduction of Chapter 6, however, this requirement was adopted in a qualified form. As a consequence, Chapter 6 requires that, in circumstances where the AER publishes a SORI on completion of a WACC review prior to the submission by a DNSP of a building block proposal, the AER's distribution determination must be consistent with a SORI unless there is persuasive evidence justifying a departure, in the particular case, from a value, method or credit rating level set out in the SORI.[241] Thus, the AER may depart from a value, method or level adopted by it in a WACC review in making a distribution determination but only where there is persuasive evidence justifying that departure.

AER's characterisation of 'the problem'

The AER has two issues with the current Rule provisions governing the determination of WACC.

First, the AER considers that there is no justification for the divergence in the process for the determination of WACC as between transmission and distribution determinations.[242] The WACC is 'predominantly based on market and sector wide benchmarks'[243] and is, thus, 'independent of business / industry specific considerations'[244]. As a consequence, the current divergence in the process for the determination of the WACC under Chapters 6 and 6A 'could produce different benchmark parameters when the risks of investment reflected in these parameters should be the same between TNSPs and DNSPs'.[245]

Secondly, the AER considers that the discretion to depart from a value, method or level adopted by it in a WACC review in making a distribution determination:

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[240] Clause 6A.6.2(h) of the Rules.

[241] Clause 6.5.4(g) of the Rules. See also clauses 6.5.4(h) and (i).

[242] AER Rule Change Proposal, pp16, 65, 67.

[243] AER Rule Change Proposal, p67.

[244] AER Rule Change Proposal, p65.

[245] AER Rule Change Proposal, p67.

- is unnecessary as 'most WACC parameters [are] slow to change with developments in data and theory';[246]
- results in the 'continual assessment of similar arrangements and evidence at each determination process' and an associated 'high administrative burden';[247]
- enables 'DNSPs to cherry pick those component parameters of the WACC which they consider unfavourable for them' which, in turn, 'detracts from the AER's ability to adequately consider the resulting overall rate of return';[248] and
- as the AER's determination of values, methods or levels in distribution determinations is subject to merits review by the Tribunal, 'has also resulted in reviews by the Australian Competition Tribunal in pursuing a level of precision which can only be considered spurious in the context of many WACC parameters'.[249]

The AER asserts that the requirement for persuasive evidence for any departure from WACC review outcomes in the making of a distribution determination has not been effective in discouraging DNSPs from repeating and repackaging data and theoretical arguments, and 'attempting to cherry pick certain parameters'.[250] The AER, therefore, takes the view that the process for determination of the WACC established by Chapter 6A is to be preferred.[251]

In support of its views, the AER relies on the AEMC's rationale for adopting a WACC determination process in Chapter 6A that does not permit WACC review outcomes to be revisited in the making of transmission determinations. The AER asserts that the AEMC's decision to adopt such an approach was based on:[252]

- the existence of a high degree of stability in parameter values adopted by regulators in the years preceding the AEMC's 2006 TNSP Rule Determination and the AEMC's resultant view that periodic WACC reviews would provide sufficient flexibility to address developments in theory and market conditions; and
- the savings in administrative costs and increased investment certainty delivered by requiring WACC review outcomes to be applied in making transmission determinations.

The AER takes the view that these considerations are equally relevant to the making of distribution determinations.[253]

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[246] AER Rule Change Proposal, p65. See also p69.

[247] AER Rule Change Proposal, p16. See also pp65, 69.

[248] AER Rule Change Proposal, p65. See also p69.

[249] AER Rule Change Proposal, p65.

[250] AER Rule Change Proposal, p68.

[251] AER Rule Change Proposal, p65.

[252] AER Rule Change Proposal, pp67, 70.

[253] AER Rule Change Proposal, p67.

The AER also relies (selectively) on the MCE's rationale for adopting a different approach for WACC determination in Chapter 6 to that adopted by the AEMC. The AER asserts that:[254]

- the MCE's decision to provide limited flexibility to revisit WACC review in making distribution determinations was based on the pre-existing differences in WACC parameters across jurisdictions; and
- as the AER's 2009 WACC Review resulted in 'an immediate convergence in parameters from previous jurisdictional outcomes ... the MCE's rationale for different WACC frameworks falls away'.

AER's proposed Rule changes

The AER's proposed Rule changes effect convergence in the process for determination of the WACC specified in Chapters 6 and 6A of the Rules. They do this by:

- replacing the term 'statement of regulatory intent' in Chapter 6 with the term 'statement on the cost of capital', as the AER's decision on values, methods and/or credit rating levels in a WACC review under Chapter 6 would no longer constitute a statement of its future regulatory intent;[255]
- amending the provisions of Chapter 6 to provide that the WACC in a distribution determination must be calculated in accordance with the SOCC;[256]
- removing the provisions of Chapter 6 governing the AER's discretion to depart from a value, method or level in the SORI if justified;[257] and
- amending the Chapter 6A provisions to mirror the form of the Chapter 6 provisions.[258]

Businesses' Response

Convergence of WACC determination framework for transmission and distribution is desirable in principle but should be based on Chapter 6 not Chapter 6A

The Businesses agree, in principle, with the establishment of a single, common WACC review process for electricity transmission and distribution. A single, common WACC review process under Chapters 6 and 6A of the Rules is desirable because, as recognised by the AEMC in establishing the WACC review process in Chapter 6A[259]:

- the values of at least some WACC parameters (for example gamma, equity beta and the debt to equity ratio) are relatively stable and slow to change; and

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[254] AER Rule Change Proposal, p67.

[255] AER Draft Rules, pp19, 21, 146 (proposed clauses 6.5.2(b)(2), 6.5.4(f)-(g) and Chapter 10 definition of 'statement on the cost of capital').

[256] AER Draft Rules, pp19, 21 (proposed clauses 6.5.2(b)(2), 6.5.4(g)).

[257] Clauses 6.5.4(h)-(i) of the Rules.

[258] AER Draft Rules, pp79-80, 82-83 (proposed clauses 6A.6.2(b)(2), (e), (h)-(i)).

[259] 2006 TNSP Rule Determination, p82.

- certainty and predictability in the return network service providers can expect to earn on their investments is desirable for the creation of incentives for, and the promotion of, efficient investment and, thus, the achievement of the NEO.

While the Businesses consider that administrative costs should not be a determinative consideration, the Businesses acknowledge that amendments to the Rules to ensure the AER can conduct a single, common WACC review process for both transmission and distribution would also deliver administrative cost savings.

Further, the Businesses acknowledge that there is no readily apparent justification for the difference in the WACC determination frameworks as between Chapters 6 and 6A. However, the Businesses contend that any convergence in the WACC determination frameworks as between Chapters 6 and 6A in relation to the application of WACC review outcomes in individual determinations should be based on Chapter 6, and not Chapter 6A as proposed by the AER.

Contrary to the AER's assertions, the available evidence discloses that the requirement under Chapter 6 of the Rules for a distribution determination to which a SORI is applicable to be consistent with that SORI unless there is persuasive evidence justifying a departure from a value, method or credit rating level set out in that SORI has been highly effective in minimising:

- debate in distribution determination processes on the application of SORI outcomes; and
- Tribunal reviews of those determinations in respect of those elements of WACC estimation that were the subject of the SORI.

By contrast, it is a necessary consequence of the lack of scope to revisit WACC review outcomes in making transmission determinations under Chapter 6A of the Rules that there is no flexibility between reviews to respond to changes in market conditions in estimating WACC and no availability of merits review by the Tribunal for WACC decision-making under Chapter 6A[260]. It follows that the AER's proposed Rule change would have the effect of removing the existing flexibility under Chapter 6 to respond to changes in market conditions in estimating WACC for individual distribution determinations and foreclosing merits review on decisions on WACC occurring in WACC reviews.

The Businesses submit, therefore, that any convergence of the provisions of Chapters 6 and 6A with respect to the scope to revisit WACC review outcomes in making individual determinations should be based on Chapter 6 of the Rules. The Businesses consider that the (limited) scope to revisit WACC review outcomes in making determinations provided by Chapter 6 is critical to:

[260] Merits review by the Tribunal is available only for 'reviewable regulatory decisions': section 71B of the Law. The term 'reviewable regulatory decision' is confined to a transmission determination or distribution determination that sets a regulatory control period, or any other determination or decision of the AER under the Rules that is prescribed by the Regulations to be a 'reviewable regulatory decision': section 71A of the Law; definition of 'network revenue or pricing determination' in section 2 of the Law. The Regulations prescribe an AER determination on an approved pass through amount in the case of a positive change event or required pass through amount in the case of a negative change event, and the amount thereof to be recovered from users in each year of a regulatory control period to be a 'reviewable regulatory decision' for the purposes of the Law: regulation 9; clauses 6.6.1(d), (g), 6A.7.3(d), (g) of the Rules. A transmission or distribution determination is a 'reviewable regulatory decision' and, thus, subject to potential merits review but an AER decision in a WACC review is not.

- providing required flexibility for the rate of return to reflect changes in market conditions, such as the GFC, and the associated data or information issues that may arise in individual determination processes; and

- delivering accountability in, and an avenue for scrutiny and oversight of, AER decision-making on WACC, through the availability of merits review by the Tribunal.

Given the implications of the determination of the rate of return to incentives for efficient investment, the Businesses consider the above matters should be determinative in the AEMC's consideration of the AER's proposal for removal of the existing scope under Chapter 6 to revisit WACC outcomes in individual determinations.

These reasons for considering that Chapter 6 is to be preferred to Chapter 6A as the basis for any convergence are entirely consistent with the MCE's rationale for providing limited flexibility to revisit WACC review outcomes in making distribution determinations at the time of introducing Chapter 6.

Requirement for persuasive evidence before departing from SORI in distribution determination highly effective

The requirement under Chapter 6 of the Rules for a distribution determination to which a SORI is applicable to be consistent with that SORI unless there is persuasive evidence justifying a departure from a value, method or credit rating level set out in that SORI has been highly effective in minimising:

- debate in distribution determination processes on the application of SORI outcomes; and

- Tribunal reviews of those determinations in respect of those elements of WACC estimation that were the subject of the 2009 SORI.

This is evident from a review of the debate regarding WACC estimation in the distribution determination processes to date to which the 2009 SORI was applicable and the Tribunal reviews of those determinations in respect of WACC estimation.

The distribution determinations to date to which the 2009 SORI was applicable are the AER's:

- Queensland Distribution Determinations for Ergon Energy and Energex for the regulatory control period 2010-11 to 2014-15;

- South Australian Distribution Determination for ETSA Utilities for the regulatory control period 2010-11 to 2014-15; and

- Victorian Distribution Determinations for CitiPower, Powercor Australia, United Energy, JEN and SPI for the regulatory control period 2011 to 2015.

The 2009 SORI did not apply to the AER's New South Wales Distribution Determinations for Country Energy (now Essential Energy), EnergyAustralia (now AusGrid) and Integral Energy (now Endeavour Energy), or ACT Distribution Determination for ActewAGL Distribution, for the 1 July 2009 to 30 June 2014 regulatory control period. This is because the Transitional Chapter 6 set out in Appendix 1 to the Rules and applicable to those Determinations under clause 11.15.2 of the Rules does not provide for this. The AER has not yet completed its first distribution determination process for the Tasmanian DNSP, Aurora Energy.

In the AER decision making processes for those distribution determinations to which the 2009 SORI was applicable, the departures from 2009 SORI outcomes ultimately proposed by the relevant DNSPs were confined to the value for gamma.[261] While certain of these DNSPs also initially proposed departures from the 2009 SORI in respect of either the MRP or the risk free rate, these departures were not ultimately pressed by any of the DNSPs before the AER. Specifically:

- ETSA and the Victorian DNSPs (but not the Queensland DNSPs) did initially propose departures from the value for the MRP determined in the 2009 SORI.[262] However, each of those DNSPs ultimately adopted the 2009 SORI value for the MRP in their revised regulatory proposals.[263]

- The Queensland DNSPs initially proposed a 'convenience yield' in addition to the risk free rate determined in accordance with the 2009 SORI.[264] However, each of those DNSPs ultimately adopted the risk free rate determined in accordance with the 2009 SORI, without any 'convenience yield', in their revised regulatory proposals.[265]

As a consequence, the Tribunal reviews of AER decisions in distribution determinations on elements of WACC estimation that were the subject of the 2009 SORI have been wholly confined to the estimation of gamma.[266] Subsequent to the Queensland, South Australian and Victorian Distribution Determinations, in the Tribunal review proceedings of their Determinations brought by ETSA Utilities and the Queensland DNSPs, the Tribunal found, based in part on an AER concession of error, that the AER had made the errors in estimating gamma in the 2009 SORI Decision and, thus, their Distribution Determinations that were asserted before the AER by the Queensland, South Australian and Victorian DNSPs.[267] The Tribunal further found that the consequence of those errors was significant, resulting in a value for gamma when corrected of 0.25 as compared to the 2009

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[261] ETSA Initial Regulatory Proposal, pp241-245; ETSA Revised Regulatory Proposal, pp190-195; CitiPower Initial Regulatory Proposal, pp304-307; CitiPower Revised Regulatory Proposal, pp355-369; Powercor Australia Initial Regulatory Proposal, pp312-315; Powercor Australia Revised Regulatory Proposal, pp346-360; SPI Initial Regulatory Proposal, pp298-302; SPI Revised Regulatory Proposal, pp323-340; JEN Initial Regulatory Proposal, pp175-179; JEN Revised Regulatory Proposal, pp242-268; United Energy Initial Regulatory Proposal, pp150-157, United Energy Revised Regulatory Proposal, pp196-212.

[262] ETSA Initial Regulatory Proposal, pp239-240; CitiPower Initial Regulatory Proposal, pp299-304; Powercor Australia Initial Regulatory Proposal, pp307-312; SPI Initial Regulatory Proposal, pp287-293; JEN Initial Regulatory Proposal, pp165-172; United Energy Initial Regulatory Proposal, pp139-146.

[263] ETSA Revised Regulatory Proposal, p190; CitiPower Revised Regulatory Proposal, pp348-353; Powercor Australia Revised Regulatory Proposal, pp339-344; SPI Revised Regulatory Proposal, pp303-306; JEN Revised Regulatory Proposal, p225; United Energy Revised Regulatory Proposal, pp176-185.

[264] Ergon Energy Initial Regulatory Proposal, p387; Energex Initial Regulatory Proposal, pp238, 240-241.

[265] Ergon Energy Revised Regulatory Proposal, p186; Energex Revised Regulatory Proposal, p37.

[266] These Tribunal reviews have been confined to the review proceedings brought by Energex, Ergon Energy and ETSA Utilities in ACT Nos 2 to 4 of 2010 and the review proceedings brought by the Victorian DNSPs in ACT Nos 6 to 10 of 2010.

[267] *Application by Energex Limited (No 2)* [2010] ACompT 7. The AER conceded error in the estimation of the distribution ratio and the Tribunal accepted this concession in finding that error occurred in the AER's determination of the distribution ratio: see [51]-[52]. In addition, the Tribunal found error occurred in the AER's determination of utilisation rate (or theta): see [89].

SORI value of 0.65.[268] The AER has since conceded, in the current Tribunal review proceedings brought by the Victorian DNSPs, that it repeated certain of these estimation errors in making the Victorian Distribution Determinations and, thus, the appropriate value for gamma for the purposes of those Determinations is also 0.25.[269]

Further, as discussed in greater detail below, the departures from the 2009 SORI initially proposed (but not ultimately pressed) in respect of the value of the MRP and the estimation of the risk free rate were proposed by the relevant DNSPs on the basis of the impact of the GFC on the estimation of those parameters, both of which are sensitive to changes in market conditions.

Thus, the available evidence discloses that the scope to revisit WACC review outcomes in the making of distribution determinations provided under Chapter 6 of the Rules, confined as it is by the requirement for persuasive evidence justifying any departure from those WACC review outcomes, has not detracted from the application of WACC review outcomes in those distribution determinations to which they apply. To the contrary, the requirement for persuasive evidence has been highly effective in:

- limiting the number and extent of the challenges before the AER and in Tribunal reviews to the application of WACC review outcomes in distribution determinations; and
- confining those challenges that do occur to the application of WACC review outcomes to circumstances where:
    - the AER has made manifest and significant errors in estimating parameters in the WACC review; or
    - to a lesser extent, the estimation of those parameters is sensitive to changes in market conditions post-dating that review.

Flexibility to address changes in market conditions in determinations is required

As recognised by the Tribunal, the rate of return applied by the AER in making a transmission or distribution determination should in principle be the rate of return required by investors in the regulatory control period in which it is to be applied.[270] This, in turn, necessitates the flexibility to revisit the estimation of certain of the parameter values that are sensitive to changes in market conditions, in particular the DRP, risk-free rate and the MRP.

While the AER contends in the AER Rule Change Proposal that 'most' WACC parameters are stable and slow to change,[271] it has been recognised by:

- the Tribunal in respect of the risk-free rate and the DRP that those parameter values are sensitive to market conditions and would be expected to vary from one year to the next;[272] and

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[268] *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9, [42].

[269] *Joint Submissions of the Australian Energy Regulator and the Applicants in relation to Gamma* filed in the Tribunal in ACT File Nos 6 to 10 of 2010 on 11 July 2011.

[270] *Application by EnergyAustralia and Others* [2009] ACompT 8, [86], [93]-[94].

[271] AER Rule Change Proposal, p65. See also p69.

- by the AER in its 2009 SORI Decision that the risk-free rate and the MRP are sensitive to changes in market conditions[273] and in the AER Rule Change Proposal that this is also true in respect of the DRP.[274]

The AER itself acknowledged, in its 2009 SORI Decision, the need for the estimation of the risk-free rate (and by implication the DRP) to be updated at the time of determinations given their sensitivity to market conditions.[275]

The recent experience of WACC estimation during and subsequent to the GFC further evidences the sensitivity of the MRP and DRP to changes in market conditions, as well as the need for greater flexibility to reflect changes in market conditions in the estimation of those WACC parameters, such as the MRP, the DRP and the risk-free rate, that are sensitive to such changes than is delivered by the framework under Chapter 6A of the Rules.

First, the AER's own approach to estimation of the MRP at the time of the GFC and subsequently discloses the need for greater flexibility to reflect changes in market conditions than is provided by WACC reviews at approximately five yearly intervals.

In its 2009 SORI Decision, the AER determined, as a consequence, of the GFC to increase the MRP to 6.5% from its long term historical MRP of 6.0%.[276] The AER did so for the reason that the current estimate of the MRP was significantly higher than the long term historical MRP, which was explicable on the basis that either:[277]

- the then prevailing medium term MRP was above the forward looking long term MRP but would return to that long term MRP over time; or
- there has been a 'structural break' in the MRP as a consequence of the GFC with the result that the forward looking long term MRP (and consequently the then prevailing MRP) is above the long term historical MRP.

The AER considered that both explanations for the divergence in the then prevailing MRP from its long term historical level suggested that an MRP of above 6% may be reasonable and concluded that an MRP of 6.5% was 'an estimate of a forward looking long term MRP commensurate with the conditions in the market for funds that are likely to prevail at the time of the reset determinations to which [the 2009 WACC] review applies'.[278]

However, in June 2011, just over 2 years after publication of the 2009 SORI, the AER determined that the best estimate of the MRP was 6% in its access arrangement decisions for Envestra's South

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[272] *Application by EnergyAustralia and Others* [2009] ACompT 8, [89]-[90].

[273] 2009 SORI Decision, pp235, 237-238. The AER observed, at p235, that 'the risk-free rate is not stable over time, but varies'.

[274] AER Rule Change Proposal, pp78-79.

[275] 2009 SORI Decision, p235.

[276] 2009 SORI Decision, pp237-238.

[277] 2009 SORI Decision, p238.

[278] 2009 SORI Decision, p238.

Australian and Queensland gas networks.[279] The AER concluded that its approach of increasing the MRP to 6.5% in the 2009 SORI at the time of the GFC was no longer appropriate as economic and financial market conditions since the GFC had significantly improved and the uncertainty associated with the effects of the GFC on future market conditions had reduced.[280] If, however, the AEMC were to effect convergence of the WACC determination frameworks for electricity transmission and distribution and gas on the basis of Chapter 6A of the Rules as proposed by the AER, it would have had no flexibility to respond to this perceived change in prevailing market conditions in making its access arrangement decisions for Envestra.

Similarly, in its Tasmanian Distribution Determination Draft Decision for the 1 July 2012 to 30 June 2017 regulatory control period published by the AER on 30 November 2011, the AER availed itself of the flexibility to revisit 2009 SORI outcomes in making distribution determinations afforded by Chapter 6, determining that there is persuasive evidence justifying a departure from the 2009 SORI value for the MRP of 6.5%, and instead adopting a value of 6%, for the purposes of that Distribution Determination. Once again, the AER's decision was based on improvements in economic and financial market conditions subsequent to the 2009 SORI and the availability of new information and data on the MRP prevailing in those improved market conditions.[281] By contrast, as a consequence of the lack of scope under Chapter 6A to revisit WACC review outcomes in making transmission determinations, the AER adopted the 2009 SORI value for the MRP of 6.5% in making its contemporaneous Queensland Transmission Determination Draft Decision for Powerlink for the same regulatory control period[282], despite holding the view that this value 'is no longer appropriate'.[283]

Secondly, while estimation of the DRP is not currently the subject of WACC reviews occurring under Chapters 6 and 6A, the AER's experience in respect of the estimation of the DRP at the time of the GFC and subsequently also demonstrates the need for greater flexibility to reflect changes in market conditions than is provided by five yearly WACC reviews.

In proposing the removal of the existing definition of the DRP in the Rules in the AER Rule Change Proposal, the AER asserts that flexibility in respect of the estimation methodology for the DRP is required as benchmark financing structures can change over time with changing market conditions, which can, in turn, necessitate changes in estimation methodologies to address data availability issues and ensure that the value of the DRP reflects the efficient costs of debt. The AER cites, by way of example, the difficulties it has experienced in estimating the DRP in accordance with the Rules' definition of the DRP at the time of the GFC and subsequently.[284]

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[279] AER, *Final decision Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011-30 June 2016* dated June 2011, pp52-53; AER, *Final decision Envestra Ltd Access arrangement proposal for the Qld gas network 1 July 2011-30 June 2016* dated June 2011, pp47-48.

[280] AER, *Final decision Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011-30 June 2016* dated June 2011, pp50-51 and Appendix A, pp197-198; AER, *Final decision Envestra Ltd Access arrangement proposal for the Qld gas network 1 July 2011-30 June 2016* dated June 2011, pp45-46 and Appendix A, pp185-186.

[281] Tasmanian Distribution Determination Draft Decision, pp27-28.

[282] Queensland Transmission Determination Draft Decision, p33.

[283] Tasmanian Distribution Determination Draft Decision, p28.

[284] AER Rule Change Proposal, pp78-79.

The AER proposes that the need for increased flexibility to respond to changing market conditions in estimating the DRP be addressed by amending the Rules to provide for the value and methodology of estimation of the DRP to be considered periodically in WACC reviews.[285] The Businesses observe, however, that a consideration of the relative timing of the introduction of Chapters 6 and 6A including in particular the existing Rules' definition of the DRP and of the issues experienced in estimating the DRP as a consequence of the GFC suffices to demonstrate that the periodic review of the value and method of estimation of the DRP in WACC reviews will not suffice to deliver the required flexibility to respond to changing market conditions.

Chapters 6 and 6A and the existing Rules' definition were introduced in 2007 and 2006 respectively. The AER acknowledges that, at that time, the existing Rules' definition of the DRP represented current practice which, in turn, reflected the market conditions prevailing at that time.[286] However, the data issues associated with the GFC began to emerge contemporaneously with the introduction of Chapters 6 and 6A and reached their zenith in 2008.[287] This discloses the need for a greater level of flexibility than that delivered by periodic WACC reviews at approximately 5-yearly intervals.

The lack of flexibility to revisit WACC review outcomes in making transmission determinations under the Chapter 6A framework for the determination of WACC would, if adopted as the basis for convergence, have the consequence that certain TNSPs and DNSPs would:

- be subject to a rate of return that, even at the commencement of the period in which it was to apply, would be premised on parameter values estimated, in a WACC review, three years previously; and
- continue to be subject to that rate of return over eight years after the estimation of those parameter values.

By way of illustration, the 2009 SORI published by the AER on 1 May 2009 will apply to the determination of the rate of return for the purposes of the AER's transmission determination for Powerlink for the regulatory control period from 1 July 2012 to 30 June 2017 and the AER's distribution determination for Aurora Energy for that same regulatory control period. As a consequence of the lack of flexibility under Chapter 6A to revisit WACC review outcomes in making transmission determinations, there is no scope for the AER to revisit the appropriateness of the use of the parameter values estimated in the 2009 SORI in estimating a rate of return to apply in the five years commencing 1 July 2012 in making Powerlink's transmission determination. In particular, Powerlink will be subject to an MRP value determined in 2009 that the AER now considers to be inappropriate until 30 June 2017, some eight years after the time at which that MRP value was considered appropriate. If the AEMC amends the Rules as proposed by the AER to remove the definitions of the DRP and risk-free rate (both of which are sensitive to changing market conditions) and provide for their value and method of estimation to form part of the WACC reviews, this will exacerbate the undesirability of such an outcome.

By contrast, the scope under Chapter 6 to revisit WACC review outcomes in the making of determinations mitigates the potential for the WACC applicable to a DNSP under its distribution

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[285] AER Rule Change Proposal, pp80-81.

[286] AER Rule Change Proposal, p78.

[287] AER Rule Change Proposal, p78. The AER observes that 'the last time an Australian dollar denominated ten year corporate bond with a BBB+ credit rating was issued in the Australian bond market was June 2006'.

determination to diverge from the then prevailing efficient rate of return as a consequence of changes in market conditions over time.

Availability of merits review by Tribunal is required

The Tribunal reviews of AER WACC decisions in the period since the introduction of Chapter 6 in its current form demonstrate the importance of accountability in, and an avenue for scrutiny and oversight of, AER decision-making on WACC. For this reason alone, the scope under Chapter 6 to revisit WACC review outcomes in making distribution determinations should be retained unless and until the AER's WACC review decision is subject to merits review.

Far from disclosing that merits reviews of WACC to date have involved the pursuit of a 'spurious' level of precision in parameter value estimation, an examination of the Tribunal's reviews to date demonstrates that the availability of merits review has been essential to the robust and reliable estimation of WACC and investor confidence in WACC estimation. By way of summary of the Tribunal's reviews of AER WACC decisions to date:[288]

- In the New South Wales DNSPs Review brought by EnergyAustralia (now AusGrid), Integral Energy (now Endeavour Energy) and Country Energy (now Essential Energy) (ACT File Nos 2, 4 and 6 of 2009):[289]
    - the DNSPs contended error by the AER in its decision to withhold its agreement to their proposed averaging periods for use in estimating the risk free rate and in the methodology for estimating the DRP; and
    - the Tribunal found error by the AER in its decision regarding the averaging period for estimation of the risk free rate.
- In the South Australian and Queensland DNSPs Review brought by ETSA Utilities, Energex and Ergon Energy (ACT File Nos 2 to 4 of 2010):[290]
    - the DNSPs contended that the AER erred in its decision to apply the value of gamma estimated in the 2009 SORI by reason of errors in that estimation;
    - the AER conceded error in the estimation of the distribution ratio used to estimate the value of gamma and, thus, the value for gamma applied in the South Australian and Queensland Distribution Determinations;
    - the Tribunal found error in the estimation of both the distribution ratio and the franking credit utilisation rate (or theta); and

[288] The Queensland and South Australian gas distribution network service providers, APT Allgas and Envestra, also commenced review proceedings in July 2011 (ACT File Nos 5 to 7 of 2011). APT Allgas and Envestra allege error in the AER's methodology and estimation of the DRP and Envestra also alleges error in the estimation of the MRP. These review proceedings are, however, in their early stages.

[289] *Application by EnergyAustralia and Others* [2009] ACompT 8, [91]-[92], [107], [116], [117], [125], [127].

[290] *Application by Energex Limited (No 2)* [2010] ACompT 7, [52], [87], [89], [145]; *Application by Energex Limited (Distribution Ratio (Gamma)) (No 3)* [2010] ACompT 9, [4]; *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9, [37], [42].

    - the Tribunal ultimately determined that the appropriate value for gamma was 0.25 as compared to the 2009 SORI value for gamma of 0.65.

- In the ACT gas distribution network service provider review brought by ActewAGL Distribution (ACT File No 1 of 2010), ActewAGL Distribution contended that the AER erred in its methodology for estimation of the DRP and the Tribunal agreed.[291]

- In the New South Wales gas distribution network service provider review brought by JGN (ACT File No 5 of 2010):[292]

    - JGN contended that the AER made errors in its methodology for estimation of the DRP and the same errors in its methodology for estimation of gamma found in the South Australian and Queensland DNSPs' Review;

    - the AER conceded error in its methodology for estimation of the DRP; and

    - the Tribunal agreed that the AER had made the errors in its methodology for estimation of the DRP alleged by JGN and adopted its earlier findings of error in respect of the AER's methodology for estimation of gamma.

- In the Victorian DNSPs Review brought by CitiPower, Powercor Australia, JEN, SPI and United Energy (ACT File Nos 6 to 10 of 2010) which proceedings are yet to be determined by the Tribunal:

    - the DNSPs contended that the AER made the same errors in its methodology for estimation of gamma found in the South Australian and Queensland DNSPs Review and an error in its methodology and estimation of the DRP;

    - the AER has conceded error in the estimation of the franking credit utilisation rate (or theta) used to estimate the value of gamma and that it would be appropriate to apply the value for gamma previously determined by the Tribunal of 0.25;[293] and

    - the AER has also conceded the error in its methodology and estimation of the DRP alleged by the Victorian DNSPs.[294]

As is evident from the above, the Tribunal's reviews of WACC decisions to date disclose:

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[291] *Application by ActewAGL Distribution* [2010] ACompT 4, [80]. While not material to the Tribunal's finding of error, the AER agreed that there had been some errors in the application of statistical tests in estimating the DRP: see [71].

[292] *Application by Jemena Gas Networks (NSW) Ltd (No 5)* [2011] ACompT 10, [13], [86], [91]-[92].

[293] *Joint Submissions of the Australian Energy Regulator and the Applicants in relation to Gamma* filed in the Tribunal in ACT File Nos 6 to 10 of 2010 on 11 July 2011.

[294] *The Australian Energy Regulator's Outline of Submissions concerning Debt Risk Premium: "Annualisation Error"* filed in the Tribunal in ACT File Nos 6 to 9 of 2010 on 18 March 2011. JEN alleged further errors in the estimation of the DRP which were not alleged by the other Victorian DNSPs. These errors alleged by JEN are contested by the AER.

- the real potential for AER errors in WACC decision making including in particular in WACC reviews and the potential significance of those errors;

- the important role that Tribunal reviews of AER WACC decisions have played in correcting AER errors in WACC decisions including in making the 2009 SORI Decision; and

- the resultant need for the accountability and oversight of AER decision-making on WACC that is provided by the availability of merits review of WACC decisions under Chapter 6 of the Rules.

By contrast, the lack of merits review under the Chapter 6A framework for the determination of WACC prevents the adoption of the appropriate parameter value in transmission determinations, even where the AER is aware that the value determined in the WACC review is subject to a fundamental estimation error. This is more than a theoretic concern. The framework for determining the WACC under Chapter 6 means that the TNSPs remain subject to a gamma parameter value that the Tribunal has found, and the AER conceded, is the subject of error and which diverges significantly (0.65 determined in the AER's 2009 WACC Review as compared to the value for gamma of 0.25 determined by the Tribunal) from the appropriate value.

While judicial review of AER WACC decisions is available under Chapter 6A (as it is for WACC decisions under Chapter 6), the recent Federal Court decision in *ActewAGL Distribution v The Australian Energy Regulator* [2011] FCA 639 discloses that judicial review is not an alternative to merits review for the correction of AER error in estimating WACC values.

In that decision, the Court considered an application by ActewAGL Distribution for judicial review of the AER's decision in making its distribution determination for the period 1 July 2009 to 30 June 2014 not to approve the averaging period proposed by ActewAGL Distribution for use in estimation of the risk-free rate, together with an application for an extension of time within which to make that application. EnergyAustralia, Integral Energy and Country Energy challenged the AER's approach, in the AER's contemporaneous distribution determinations applicable to them, to the averaging period used in estimating the risk-free rate in the New South Wales DNSPs review before the Tribunal but ActewAGL Distribution chose not to do so. ActewAGL Distribution's application for judicial review was an attempt to secure an outcome in conformity with the Tribunal's decision that the AER's decision not to approve the proposed averaging periods was incorrect and unreasonable.

In considering the merits of ActewAGL Distribution's substantive application for the purpose of determining whether to exercise its discretion to grant the extension of time, the Court:

- emphasised that it did not follow from the Tribunal's decision in the New South Wales DNSPs Review that ActewAGL Distribution had a strong case, as the mere fact that the AER exercised its discretion incorrectly or unreasonably does not suffice to establish the unreasonableness ground of judicial review;[295] and

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[295] *ActewAGL Distribution v The Australian Energy Regulator* [2011] FCA 639, [113], where the Court stated: 'The decision in *EnergyAustralia* was based on the application of a different test and does not speak to the strength of ActewAGL Distribution's application for judicial review. The Tribunal proceeded on the basis that, if it was of the view that the AER unreasonably withheld its agreement, this could amount to either an incorrect exercise of the discretion in all the circumstances or the decision being unreasonable in all the circumstances, each of which is an available ground of review in the Tribunal: *EnergyAustralia* at [69(k)]. It went on to find (at [100]) that in July 2008 the AER had unreasonably withheld its agreement. The task confronting this Court on judicial review, however, is quite different from the task the Tribunal faced. This

- ultimately concluded, despite the Tribunal's findings in the New South Wales DNSPs review, that ActewAGL Distribution's case on judicial review was not a strong one.[296]

In short, the Court's decision establishes that, unlike merits review, judicial review may not provide an avenue for the correction of an AER decision on WACC that is incorrect or unreasonable.

Convergence based on Chapter 6 is consistent with MCE's rationale for flexibility to revisit WACC outcomes in making distribution determinations

The Businesses reasons for considering that Chapter 6 is to be preferred to Chapter 6A are entirely consistent with the MCE's rationale for providing limited flexibility to revisit WACC review outcomes in making distribution determinations. Contrary to the AER's characterisation of that rationale as based solely on the pre-existing differences in WACC parameters across jurisdictions, the MCE's decision was also based on:

- the MCE's recognition of the need for greater flexibility to reflect market dynamics and realities in the WACC than was available under Chapter 6A where WACC review outcomes could not be revisited in making individual determinations; and

- the MCE's acceptance that merits review should be available for WACC decisions under Chapter 6.

This is readily apparent from the SCO response to stakeholder comments on the exposure draft to Chapter 6 of the Rules.[297] In that response, SCO responded to a stakeholder submission to the effect that WACC parameters and methodologies should not fall outside the merits review framework because this reduced accountability on a significant aspect of the determination by stating that 'it is not appropriate for merits review to apply to the 5 year review' but that '[t]he distribution rules will be amended so that WACC will be subject to merits review on a determination by determination basis'.[298] SCO also accepted a stakeholder submission to the effect that fixing WACC parameters over a long period may hinder the ability for the WACC to reflect market dynamics and realities, stating by way of response that the Rules would 'afford flexibility in the application of WACC parameters for such events'.[299]

It follows that the AER's assertion that, with the 'convergence in parameters from previous jurisdictional outcomes' effected by the 2009 WACC Review, the MCE's rationale for the differing

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Court is not concerned to determine whether the AER unreasonably withheld agreement to ActewAGL Distribution's proposals. The Tribunal's views about the merits of that decision, or mine for that matter, are irrelevant. While unreasonableness is also a ground of judicial review, the ADJR Act does not authorise the correction of unreasonable decisions, only those where the exercise of the discretion was so unreasonable that no reasonable person could have so exercised it...'.

[296] *ActewAGL Distribution v The Australian Energy Regulator* [2011] FCA 639, [114]-[115].

[297] SCO, *SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, accompanying SCO's *Energy Market Reform Bulletin No. 95* dated 1 August 2007.

[298] SCO, *SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, item no 49.

[299] SCO, *SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, item no 51.

WACC framework in Chapter 6 of the Rules 'falls away' is not sustainable. To the contrary, the MCE's rationale for the differing WACC framework in Chapter 6 of the Rules supports the Businesses' view that any convergence between Chapters 6 and 6A in respect of the scope to revisit WACC review outcomes in individual determinations should be based on Chapter 6.

While not quibbling with the AER's right to change its position, the Businesses further observe that their view that Chapter 6 is to be preferred to Chapter 6A and the first of their reasons for that view are entirely consistent with the views expressed by the AER itself in the AEMC's consultation on Chapter 6 in 2006 and the SCO's consultation on the exposure draft of Chapter 6 in 2007. Before the AEMC, the AER contended that a five-yearly WACC review was unduly restrictive and proposed instead that it have power to review individual WACC parameters 'as information becomes available'.[300] Further, the AER was one of the stakeholders to whom SCO ascribed the submission that fixing parameters over a long period of time may hinder the ability for the WACC to reflect market dynamics and realities.[301] As noted above, it was in response to this very submission that the MCE determined to provide scope under Chapter 6 to revisit WACC review outcomes in distribution determinations.

Developments subsequent to the MCE's decision to provide (limited) scope to revisit WACC review outcomes in the making of distribution determinations, discussed above, only serve to underline the need for that scope identified by the MCE.

AER's asserted deficiencies in Chapter 6 framework for WACC determination are unfounded

The AER has asserted five key deficiencies in the Chapter 6 framework for WACC determination in proposing that convergence of the WACC determination frameworks in Chapter 6 and 6A be based on that in Chapter 6A. None of these assertions of deficiency in the Chapter 6 framework withstand scrutiny.

First, the AER contends that the discretion to depart from WACC review outcomes in making a distribution determination is unnecessary. This contention is incorrect.

Whereas the AER contends that this discretion is unnecessary because 'most' WACC parameters are stable and slow to change[302], the DRP, risk-free rate and MRP - that is, three of the six WACC parameters - are sensitive to changes in market conditions. As discussed above, this is evident from the recent experience of WACC estimation during and subsequent to the GFC and has also been recognised by the Tribunal, in respect of the risk-free rate and the DRP, and by the AER itself in respect of all three parameters.

Similarly, the AER's assertion that the MCE's rationale for providing flexibility to revisit WACC review outcomes in making distribution determinations under Chapter 6 fell away following convergence in parameters from previous jurisdictional determinations in the 2009 SORI is not sustainable because, for the reasons discussed above, the pre-existing divergence of jurisdictional WACC outcomes was one only of a number of considerations that informed the MCE's decision to provide this flexibility in Chapter 6 of the Rules.

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[300] 2006 TNSP Rule Determination, p84.

[301] SCO, *SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, item no 51.

[302] AER Rule Change Proposal, p65. See also p69.

Secondly, the AER characterises distribution determination processes as involving the continual re-agitation by DNSPs and resultant reassessment by the AER of WACC issues already canvassed and determined by the AER at each distribution determination. It further asserts that this occurs at a high administrative cost and in circumstances where the AER has already undertaken a thorough review considering all stakeholders views and interests in a WACC review and parameters should not change over the short to medium term and therefore, by inference, for no benefit.[303] This characterisation is inaccurate and misleading.

The experience in distribution determination processes to date discloses that the subject of DNSP submissions in those distribution determination processes (and subsequent Tribunal reviews) has been largely confined to:

- the impact of the GFC on the estimation of those WACC parameter values that (as established by the discussion above) are sensitive to changes in market conditions, namely the DRP and the MRP; and

- errors made in the estimation of gamma in the 2009 SORI Decision, which errors have been subsequently conceded by the AER and/or found by the Tribunal with the consequence that the Tribunal concluded the appropriate value for gamma was 0.25 rather than the value for gamma of 0.65 determined by the AER in the 2009 SORI.

Thus, the re-agitation by DNSPs, and resultant reassessment by the AER of WACC issues at each distribution determination, to which the AER refers has occurred in the context of parameters that are sensitive to continually changing market conditions or have been subsequently conceded by the AER and found by the Tribunal to be subject to estimation errors repeated by the AER at each distribution determination. Further, the experiences in those distribution determination processes to date disclose that, in so doing, the DNSPs do not solely repeat and repackage previous data and theory as the AER asserts,[304] but instead adduce new empirical evidence and expert material.

By way of illustration, in its distribution determination process, ETSA Utilities proposed departures from the 2009 SORI only in respect of:

- gamma, on the basis that the methodology and certain of the material relied on by the AER in determining a value for gamma of 0.65 in the 2009 SORI was made available only at the time of the 2009 SORI Decision, with the consequence that the ETSA Utilities distribution determination process provided the first opportunity for ETSA Utilities to comment on these and adduce new evidence on the issues raised by them, and that the new evidence adduced by ETSA Utilities demonstrated that the AER erred in estimating gamma in the 2009 SORI Decision;[305] and

- the MRP, on the basis of the likely impact of the GFC on global financial markets during its regulatory control period and new empirical evidence of its impact on the cost of equity capital.[306]

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[303] AER Rule Change Proposal, pp16, 65.

[304] AER Rule Change Proposal, pp68, 69.

[305] ETSA Utilities Initial Regulatory Proposal, pp241-245; ETSA Utilities Revised Regulatory Proposal, pp190-195.

[306] ETSA Utilities Initial Regulatory Proposal, pp239-240.

Likewise, CitiPower and Powercor Australia proposed departures from the 2009 SORI, in their distribution determination processes, only in respect of:

- gamma, on the basis that the AER erred in estimating a value for gamma of 0.65 in the 2009 SORI and in reliance on new evidence post-dating the 2009 SORI Decision;[307] and
- the MRP, on the basis that new evidence relating to ongoing market volatility and the resultant spreads on bond yields relative to the MRP of 6.5% determined in the 2009 SORI disclosed that the appropriate value for the MRP was 8%.[308]

Each of ETSA Utilities, CitiPower and Powercor Australia ultimately adopted the MRP of 6.5% determined in the 2009 SORI, in their revised regulatory proposals.[309] As already discussed, subsequent to the South Australian and Victorian Distribution Determinations processes, the Tribunal found, based in part on an AER concession of error, that the AER had made the errors in estimating gamma in the 2009 SORI Decision asserted by ETSA Utilities in the South Australian Distribution Determination process and that the impact of those errors was significant, resulting in a value for gamma when corrected of 0.25 as compared to the 2009 SORI value of 0.65. The AER has since conceded, in the Victorian DNSPs review, that it repeated these estimation errors in the Victorian Distribution Determinations process.

The only other parameter that was the subject of detailed submissions by ETSA Utilities, CitiPower and Powercor Australia was the DRP, which was not the subject of the 2009 SORI. These submissions addressed, in particular, the preferred methodology for estimation of the DRP against the background of the GFC and the market conditions prevailing at the time of the determinations, and the resultant data availability issues.[310]

Accordingly, it would be erroneous to characterise the revisiting by DNSPs of WACC issues, and resultant AER reassessment of those issues, at each distribution determination, as involving high administrative cost for negligible benefit. As discussed above, the need for the AER to reassess the values for gamma and the MRP in each distribution determination process was a product of the perpetuation of AER errors in the 2009 SORI Decision in each distribution determination and changing market conditions between distribution determinations respectively. The submissions on these WACC issues in each distribution determination process have resulted in more robust and reliable estimation of an efficient rate of return and promoted investor confidence in the rate of return they will earn on their investments, which, in turn, creates incentives for efficient investment. These considerations, in the submission of the Businesses, should take precedence over considerations of administrative cost.

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[307] Powercor Australia Initial Regulatory Proposal, pp312-315; CitiPower Initial Regulatory Proposal, pp304-307; Powercor Australia Revised Regulatory Proposal, pp346-360; CitiPower Revised Regulatory Proposal, pp355-369.

[308] Powercor Australia Initial Regulatory Proposal, pp307-312; CitiPower Initial Regulatory Proposal, pp299-304.

[309] ETSA Utilities Revised Regulatory Proposal, p190; Powercor Australia Revised Regulatory Proposal, pp339-344; CitiPower Revised Regulatory Proposal, pp348-353.

[310] ETSA Utilities Initial Regulatory Proposal, p245; ETSA Utilities Revised Regulatory Proposal, p195; Powercor Australia, Initial Regulatory Proposal, pp306-307; CitiPower Initial Regulatory Proposal, pp298-299; Powercor Australia Revised Regulatory Proposal, pp331-339; CitiPower Revised Regulatory Proposal, pp340-348.

Thirdly, the AER asserts that:

- DNSPs 'cherry pick those component parameters of the WACC which they consider unfavourable for them';
- the assessment of persuasive evidence in distribution determinations is 'asymmetric' and operates to favour DNSPs; and
- this, in turn, 'detracts from the AER's ability to adequately consider the resulting overall rate of return'[311].

There is no evidence to support these AER assertions.

As discussed above, the experience in distribution determination processes to date discloses that the DNSPs' submissions on WACC have focused on those parameter values determined in the 2009 SORI that were subject to estimation error since conceded by the AER and found by the Tribunal or sensitive to volatility in market conditions, specifically gamma and the MRP respectively. The characterisation of DNSP submissions on demonstrably legitimate concerns regarding WACC estimation as 'cherry picking' of those parameters 'unfavourable' to DNSPs is misleading and unhelpful.

Further, there is no evidence of asymmetry in WACC outcomes, whether as a consequence of attempts to 'cherry pick' or the assessment of persuasive evidence. The AER does not provide any in its Rule Change Proposal, and the 2009 SORI and the distribution determinations to which that SORI was applicable do not disclose any asymmetry in changes in the credit rating level and parameter values adopted therein. The following table sets out the credit rating level and parameter values adopted by the AER in the 2009 SORI, as well as those levels and values previously adopted and those subsequently adopted by the AER in each of the distribution determinations to date to which the 2009 SORI was applicable.[312]

[311] AER Rule Change Proposal, p65. See also pp68-69.

[312] The 2009 SORI did not apply to the AER's New South Wales and ACT Distribution Determinations because the Transitional Chapter 6 set out in Appendix 1 to the Rules and applicable to those Determinations under clause 11.15.2 of the Rules does not provide for this. The AER has not yet completed its first distribution determination process for the Tasmanian DNSP, Aurora Energy.

WACC parameter	Value previously adopted[313]	SORI value[314]	ETSA[315]	Queensland DNSPs[316]	Victorian DNSPs[317]
Equity beta	1.0 (TNSPs, Vic, NSW and ACT DNSPs) 0.9 (QLD, Tas and SA DNSPs)	0.8	0.8	0.8	0.8
Market risk premium	6%	6.5%	6.5%	6.5%	6.5%
Debt to equity ratio	0.6	0.6	0.6	0.6	0.6
Credit rating level	BBB+	BBB+	BBB+	BBB+	BBB+
Assumed utilisation of imputation credits (gamma)	0.5	0.65	0.65	0.65	0.5

Table 4 - Comparison of credit rating level and parameter values in 2009 SORI and Distribution Determinations

The table discloses that:

- in the 2009 SORI, the AER concluded there was persuasive evidence to depart from the previously adopted level and values in respect of three of the five values determined by the AER in that SORI but departed from those previous levels or values in a manner unfavourable to the DNSPs in respect of two of those values and in a manner favourable to the DNSPs in respect of only one of those values; and
- in the distribution determinations to date to which the 2009 SORI was applicable, with only one exception, there have been no AER findings of persuasive evidence justifying a departure, or changes, from the level and values adopted in that SORI. The exception is that the AER adopted a value of gamma in the Victorian Distribution Determinations that departed from the 2009 SORI value and reverted to the previously adopted value of 0.5 (a change that was favourable for the Victorian DNSPs relative to the 2009 SORI but represented no change relative to the previously adopted value).

Finally, in respect of the assertion that the AER is hindered in its ability to consider the overall rate of return, the Businesses observe that the AER does not cite, in its Rule Change Proposal, any examples of instances in which DNSPs have secured a favourable change in an individual parameter value but the AER has been foreclosed from considering changes in other parameter values necessary to ensure an efficient overall rate of return. The Businesses expect that this is because there are none because, as demonstrated by Table 4above, the DNSPs have rarely secured such a change in an individual parameter value.

[313] 2009 SORI Decision, ppv, 13.

[314] 2009 SORI, p7.

[315] South Australian Distribution Determination Final Decision, ppxxiv, 193, 185.

[316] Queensland Distribution Determinations Final Decision, ppxxvii, 252, 267.

[317] Victorian Distribution Determinations Final Decision, ppviii, 514, 519.

In any event, it is open to the AER under Chapter 6 of the Rules to determine that a necessary consequence of a change in a parameter value that is favourable to the DNSP is a change in another inter-related parameter value. Any persuasive evidence justifying a departure from a SORI credit rating level or parameter value could be expected to provide persuasive evidence justifying a change in another inter-related value.

It is also open to the AER, in any Tribunal review of its WACC decision-making, to raise any consequential effect of a DNSP's review ground relating to a parameter value on another parameter value and for the Tribunal to address that effect in making its determination.[318] The Tribunal expressly recognised this in determining that the AER had erred in determining gamma in the South Australian and Queensland DNSPs' review.[319]

Fourthly, the AER asserts that the requirement for persuasive evidence for any departure from WACC review outcomes in the making of a distribution determination has not been effective. This assertion is not supported by an examination of the experience in distribution determination processes to date and in Tribunal reviews commenced by DNSPs to date.

As discussed above, the experience in the processes relating to distribution determinations to date to which the 2009 SORI was applicable disclose that the departures from 2009 SORI outcomes ultimately proposed by DNSPs before the AER have been confined to the value for gamma. With the exception only of gamma, 2009 SORI outcomes have been adopted by DNSPs in their revised regulatory proposals.

As also discussed above, the AER's decision not to depart from the 2009 SORI value for gamma is the only WACC decision in a distribution determination to which the requirement for persuasive evidence justifying a departure from a SORI value applied that has been the subject of a Tribunal review commenced by a DNSP to date. The AER's decision to this effect was the subject of the South Australian and Queensland DNSPs review and is the subject of the current Victorian DNSPs review, in both of which the AER has conceded error. This suggests that the requirement for persuasive evidence in distribution determinations has been effective both in discouraging DNSPs from challenging 2009 SORI outcomes before the AER and in limiting DNSP challenges in the Tribunal to AER decisions to apply the SORI in making those determinations.

Finally, the AER asserts that the availability of merits review by the Tribunal as a consequence of the WACC determination framework under Chapter 6 of the Rules has resulted in Tribunal reviews in pursuit of 'a level of precision which can only be considered spurious in the context of many WACC parameters'.[320] This assertion is irreconcilable with the facts relating to those reviews.

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[318] Section 71O(2) of the Law provides that the AER may raise a possible outcome or effect on the decision being reviewed that the AER considers may occur as a consequence of the Tribunal making a determination setting aside or varying the decision. Section 71P of the Law provides that the Tribunal must make a determination in respect of the application for review and that, for this purpose, may perform all the functions and exercise all the powers of the AER under the Law or the Rules.

[319] In *Application by Energex Limited (No 2)* [2010] ACompT 7 at [59], the Tribunal observed that 'in the event the Tribunal were to set aside or vary the theta aspect of the gamma constituent decision, one possible outcome or effect on each distribution determination of such a decision could be that it would be necessary for the AER to consider whether it is necessary to make any consequential adjustment to the market risk premium (MRP). The Tribunal makes this comment as it may impact upon the appropriate directions to be given.'

[320] AER Rule Change Proposal, p65.

In particular, the Tribunal reviews of WACC decisions commenced by DNSPs to date disclose that:

- the Tribunal has found error by the AER in estimating WACC in all reviews, including those brought by DNSPs, that have been determined to date;
- the AER conceded error in its estimation of gamma in its 2009 SORI Decision and its subsequent determinations, in the Queensland and South Australian DNSPs Review, the JGN Review and the Victorian DNSPs Review, and in its estimation of the DRP in its Victorian Distribution Determinations in the Victorian DNSPs Review; and
- the quantum of the divergence between the appropriate value for gamma determined by the Tribunal (i.e. 0.25) and the AER's erroneously estimated value for gamma (i.e. of 0.65 or 0.5 depending on the decision) was significant, disclosing that the 'level of precision' sought by DNSPs in the estimation of gamma could not be characterised as 'spurious'.

By contrast, for the reasons discussed above, the WACC framework under Chapter 6A, in particular the lack of any flexibility to revisit WACC parameters between WACC reviews in making individual transmission determinations, is deficient in that it fails to provide:

- the required flexibility to address changing market conditions in WACC estimation; and
- the availability of merits review of the AER's WACC decision-making to correct AER error, which has been demonstrated by the Tribunal's reviews of WACC decisions to date to be essential for robust and reliable WACC estimation and investor confidence,

these being the very reasons the MCE decided to provide this flexibility in Chapter 6 of the Rules.

Summary

The Businesses consider that, of the 'status quo', convergence of the WACC determination frameworks in Chapters 6 and 6A based on Chapter 6 and the AER's proposed Rule change, the AER's proposed Rule change is the least likely to promote the NEO and the RPPs. Under the AER's proposal, any administrative cost savings and regulatory certainty benefits would be significantly outweighed by the adverse consequences for estimation of the rate of return, investor confidence and incentives for efficient investment. These consequences arise from uncorrected AER estimation errors and parameter values to apply in determinations that diverge from their appropriate value by reason of changes in market conditions post-dating the most recent WACC review.

B.2 ROLE OF 'PERSUASIVE EVIDENCE' IN WACC REVIEWS

AER Proposed Rule Change

Current Rule provisions

Both Chapters 6 and 6A provide that, where the credit rating levels or the values attributable to, or the method of calculating, WACC parameters that are the subject of the WACC review cannot be determined with certainty, the AER must have regard to the need for persuasive evidence before adopting a level, value or method that departs from that previously adopted in undertaking the

review.[321] The AER refers to this requirement in its Rule Change Proposal as the 'persuasive evidence test' or 'persuasive evidence threshold'.

AER's characterisation of 'the problem'

The AER considers that the persuasive evidence test is 'problematic',[322] in that it is difficult to interpret and of uncertain meaning.[323] The AER places considerable emphasis, in support of this submission, on differing opinions between the AER and stakeholders in the 2009 WACC Review regarding the proper interpretation and application of the test.

Particular weight is accorded to the AER's perception that there is uncertainty as to whether the effect of the persuasive evidence test is to require the AER to demonstrate a previously adopted credit rating level, or value or method of calculation of a parameter, is incorrect before departing from it.[324] In addition, the AER contends by reference to differing opinions in the 2009 WACC Review that there is uncertainty as to:[325]

- whether unanimous evidence is required among experts before evidence can be considered 'persuasive';
- whether 'persuasive evidence' is limited to 'new' evidence; and
- whether the upper or lower 95 per cent confidence interval (depending on if the market estimates are below or above the previously adopted parameter) is the threshold that determines whether empirical evidence can be properly said to be 'persuasive'.

The AER also notes the lack of useful judicial interpretation of the persuasive evidence test.[326]

The AER further considers that the persuasive evidence test 'may inappropriately restrict the AER's ability to determine an efficient benchmark rate of return'.[327] The AER asserts that 'the persuasive evidence test has the potential (depending on how the relevant provisions are interpreted) for undue weight to be placed on consistency with previous regulatory outcomes at the expense of setting

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[321] Clauses 6.5.4(e)(4), 6A.6.2(j)(4), 6A.6.4(e) of the Rules. In addition, under Chapter 6, a distribution determination to which a SORI applies must be consistent with the credit rating levels and values attributable to, and method of calculating, WACC parameter values set out in that SORI unless there is persuasive evidence justifying a departure, in the particular case, from that level, value or method (clause 6.5.4(g) of the Rules). However, the AER's proposed Rule changes discussed in section B.1 above would, if made by the AEMC, result in the consequential removal of this requirement applicable to distribution determinations. Accordingly, the AER's proposed Rule change discussed in this section B.1 is one to remove the existing Rule requirement for the AER to have regard, in undertaking a WACC review, to the need for persuasive evidence before departing from a previously adopted level, value or method.

[322] AER Rule Change Proposal, p71.

[323] AER Rule Change Proposal, pp72-74.

[324] AER Rule Change Proposal, p72.

[325] AER Rule Change Proposal, p72.

[326] AER Rule Change Proposal, p72.

[327] AER Rule Change Proposal, p71.

parameters that are appropriate or otherwise in accordance with the interests of stakeholders'.[328] By contrast, it observes that the 'the removal of the persuasive evidence test to apply at the time of each WACC review will provide more flexibility for the AER to deal with changing market circumstances'.[329]

For these reasons, the AER contends that, rather than being required to have regard to the persuasive evidence test in undertaking a WACC review, it should only be required to have regard to previously adopted credit rating levels, and values and methods for the calculation of WACC parameters, in making its decision.

AER's proposed Rule changes

The AER proposed Rule changes amend Chapters 6 and 6A to:

- remove the requirement for the AER, in undertaking a WACC review, to have regard to the need for persuasive evidence, where the credit rating levels or the values attributable to, or the method of calculating, parameters that are the subject of the WACC review cannot be determined with certainty, before adopting a level, value or method that departs from that previously adopted;[330] and
- replace that requirement with a new requirement for the AER, in undertaking a WACC review, to have regard to the previously adopted values attributable to, or the method of calculating, WACC parameters that are the subject of the WACC review.[331]

Businesses' Response

'Persuasive evidence' requirement in WACC reviews is essential for incentives for, and promotion of, efficient network investment

The Businesses consider that the requirement for the AER to have persuasive evidence is important because:

- for at least some WACC parameters (for example gamma, equity beta and the debt to equity ratio), their value is relatively stable and slow to change;
- certainty and predictability in the return network service providers can expect to earn on their investments is important for the creation of incentives for, and the promotion of, efficient investment and, thus, the achievement of the NEO; and
- the persuasive evidence requirement delivers certainty and predictability in this rate of return by prescribing a minimum evidentiary standard for any departure from the value of

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[328] AER Rule Change Proposal, p73.

[329] AER Rule Change Proposal, p20.

[330] AER Draft Rules, pp21, 83 (proposed clauses 6.5.4(e)(4), 6A.6.2(g)(4)).

[331] AER Draft Rules, pp21, 83 (proposed clauses 6.5.4(e)(5), 6A.6.2(g)(5)). The AER's proposed clauses do not refer to credit rating levels as other elements of the AER Rule Change Proposal propose the amendment of the existing Rule provisions governing the matters that may form the subject of a WACC review so that the DRP, and not merely the credit rating levels used in its calculation, may form the subject of the review. These aspects of the AER Rule Change Proposal are discussed in section B.4 below.

those parameters that are relatively stable and slow to change and for any departure from the method of estimation of those WACC parameter values that are sensitive to changing market conditions, such as the risk free rate and MRP.

In making their investment decisions, NSPs have regard to the return they can expect to earn over the life of the asset (for distribution assets, a period of approximately 50 years), or at least the next few regulatory control periods, and not merely the return they can expect to earn over the remainder of the regulatory control period in which they make that investment. Similarly, efficient NSPs develop financing strategies, premised on the existing approach to setting the benchmark return on debt, to manage their interest rate risk. So, for example, NSPs' current financing strategies assume a forward looking risk free rate calculated over a short averaging period that is proximate to the expected date of their final determinations. These financing strategies are reflected in NSPs' existing debt and swap portfolios and, therefore, cannot be readily revisited in response to a WACC review but only in refinancing as each debt instruments matures.

Certainty and predictability of the rate of return over the next few regulatory control periods is, thus, critical to fostering efficient network investment. If there is uncertainty over the future rate of return, this can be expected to discourage efficient investment even if the rate of return in the current regulatory control period reflects the efficient rate of return required by a commercial enterprise with the same nature and degree of non-diversifiable risk as the NSP. It is this certainty and predictability as to the future rate of return that the persuasive evidence requirement in WACC reviews is intended to promote.

The Businesses' position is consistent with the conclusions reached by the AEMC regarding, and its rationale for, the existing Rule requirement to have regard to the persuasive evidence consideration in undertaking WACC reviews. In establishing the existing framework and approach in Chapter 6A of the Rules for the determination of the WACC that was subsequently adopted in Chapter 6, the AEMC recognised the 'high degree of stability in the parameter values adopted by the regulator in recent years' and premised its development of that framework and approach on the objective of 'providing a more certain and predictable environment for investment and finance decision making'.[332] The establishment of criteria and principles to which the AER must have regard in determining to vary methodologies or parameter values in WACC reviews, including in particular the persuasive evidence requirement, was intended by the AEMC to contribute to achieving this objective.[333]

While the AER refers to the existing Rule requirement for persuasive evidence in undertaking a WACC review as a 'persuasive evidence test' or 'persuasive evidence threshold' in the AER Rule Change Proposal, the existing Rule requirement is in fact one to 'have regard to' the need for persuasive evidence before departing from a previously adopted value or methodology, or credit rating level.

The AER's existing obligation is one to take into account, in undertaking a WACC review, the need for persuasive evidence and to give that need weight as a fundamental element in decision-making.[334] It is, in essence, a requirement to have due regard to historical consistency in

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[332] 2006 TNSP Rule Determination, p82. See also 2006 TNSP Draft Rule Determination, pp56-58.

[333] 2006 TNSP Rule Determination, pp82-83. See also 2006 TNSP Draft Rule Determination, p58.

[334] The phrase 'have regard to' has been consistently interpreted to mean that the decision-maker must take into account, and give genuine consideration, to the matter to which regard is to be had and give it weight as a

undertaking the review. The requirement is not one to adopt a previously adopted value or methodology, or credit rating level unless there is persuasive evidence justifying a departure. Such a requirement to 'have regard to' the need for persuasive evidence has limited scope to deliver the certainty, predictability and historical consistency in WACC outcomes that is so essential to the creation of incentives for, and promotion of, efficient network investment. Contrary to the contentions of the AER, the existing requirement to 'have regard to' the need for persuasive evidence cannot operate to require inertia around historical outcomes.

The Businesses consider that, given the importance of having a robust evidentiary basis before departing from a previously adopted value or method, or credit rating level in a WACC review, the persuasive evidence requirement applicable to WACC reviews should be in the nature of a 'test' or 'threshold', as the existing requirement is assumed to be in the AER Rule Change Proposal. Accordingly, the Businesses propose that, rather than amending the Rules to remove the existing persuasive evidence requirement applicable to WACC reviews, the AEMC should amend the Rules to require that the AER not adopt a credit rating level, or a value for, or method of calculating, a parameter that differs from that previously adopted unless there is persuasive evidence justifying that departure.

The AER's proposed Rule change, in essence, replaces one mandatory consideration with another. Instead of a requirement to 'have regard to' the need for persuasive evidence before departing from a previously adopted value or method, or credit rating level, the AER proposes a requirement to have regard only to the previously adopted value, method or level. The Businesses consider that the AER's proposed mandatory consideration will not suffice to deliver historical consistency and regulatory certainty in WACC reviews.

In contrast to the existing Rule requirement, the AER's proposed Rule requirement would not even operate to require the AER to have regard to either the importance of regulatory consistency or the desirability of robust evidence for variations in WACC outcomes in undertaking a WACC review, both of which are recognised by the AER in its Rule Change Proposal.[335] It would merely require the AER to give consideration to the values or methodologies, or credit rating levels, previously adopted. This is a consideration of a distinctly different character to that which the AEMC enshrined as a principle governing any AER determination to vary methodologies or parameter values in WACC reviews in furtherance of its object of 'providing a more certain and predictable environment for investment and finance decision making'.

The AER itself recognises the 'importance of predictability and consistency in regulatory outcomes', 'the benefits of consistency over the longer term at each WACC review' and that '[c]onsideration of past regulatory outcomes in light of current evidence is good regulatory practice' in its Rule Change Proposal.[336] However, it raises two concerns with a persuasive evidence requirement in WACC reviews, namely:

- uncertainty regarding the meaning and effect of the phrase 'the need for persuasive evidence before adopting a credit rating level or a value for, or method of calculating, that parameter that differs from' that previously adopted for it; and

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fundamental element in making the decision: *R v Hunt; Ex parte Sean Investments Pty Ltd* (1979) 180 CLR 322 at 329; *R v Toohey; Ex parte Meneling Station Pty Ltd* (1982) 158 CLR 327 at 333.

[335] AER Rule Change Proposal, pp74-75.

[336] AER Rule Change Proposal, pp74-75.

- that such a requirement 'restrict the AER's ability to determine an efficient benchmark rate of return'.

The Businesses address these AER concerns, in turn, below.

Uncertainty of meaning and effect of persuasive evidence requirement is overstated

The AER's observation that there has not been any judicial consideration of the persuasive evidence consideration is correct. There has, however, been consideration by the Tribunal of the term 'persuasive evidence' and the circumstances in which evidence will constitute 'persuasive evidence'. No mention is made of this in the AER Rule Change Proposal. However, the Tribunal's consideration of the issue significantly ameliorates the uncertainty said by the AER to arise from the lack of judicial consideration and the differing opinions of the AER and stakeholders in the 2009 WACC Review.

Subsequent to the 2009 WACC Review, the proper construction of the term 'persuasive evidence' was considered by the Tribunal in *Application by Energex Limited (No 2)* [2010] ACompT 7. While the Tribunal was considering clause 6.5.4(g) of the Rules (that is, the requirement that a distribution determination apply the SORI unless there is persuasive evidence justifying a departure from that SORI), the term 'persuasive evidence' must be given a consistent meaning in clause 6.5.4(e)(4) in imposing an obligation on the AER to have regard to the persuasive evidence consideration in undertaking WACC reviews.[337]

The Tribunal relevantly concluded that:[338]

> ...the term "evidence" refers to data or material (including expert opinion) from any source. The term is not being used in a technical legal sense, given that the AER is not a court or tribunal and is free to seek out its own data and material.
>
> Further, the adjective "persuasive" bears its ordinary meaning of able to persuade or induce a belief.

The Tribunal further concluded (at [88]) that, if on the material before it the Tribunal were to conclude that the best estimate for a parameter value was far removed from the previously adopted value, it would follow that persuasive evidence existed to justify a departure.

The Tribunal's conclusions suffice to address much of the uncertainty said by the AER to exist in respect of the construction and application of the persuasive evidence consideration.

First, the Tribunal's decision establishes that the term 'persuasive evidence' encompasses all currently available evidence and is not confined to 'new' evidence. The Businesses observe that further support for this construction is provided by the AEMC's 2006 TNSP Rule Determination, to which regard may permissibly be had in construing the persuasive evidence consideration.[339] In this

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[337] It is a fundamental rule of statutory construction that, in construing a statutory instrument, the same meaning should be given to the same words wherever they appear in that instrument: *Craig Williamson Pty Ltd v Barrowcliff* [1915] VLR 450 at 452.

[338] *Application by Energex Limited (No 2)* [2010] ACompT 7, [22]-[23].

[339] Schedule 2 to the Law, clause 8(2a), which provides that consideration may be given to Rules extrinsic material to provide an interpretation of a provision of the Rules if the provision is ambiguous or obscure, or the ordinary meaning of the provision leads to a result that is manifestly absurd or is unreasonable, and in any other case to confirm the interpretation conveyed by the ordinary meaning of the provision. The term 'Rules extrinsic material' is defined in clause 8(1) to include the 2006 TNSP Rule Determination, being a final Rule

Determination, the AEMC uses the term 'current evidence' in describing the persuasive evidence consideration to apply in WACC reviews[340] and rejects a stakeholder submission that the AER should be confined to considering new information on each parameter in those reviews, noting its expectation that 'any changes to WACC parameters will be based on all relevant currently available evidence and information'.[341]

Secondly, the Tribunal's decision establishes that to be 'persuasive' evidence must only be capable of persuading or inducing a belief. It follows that there is no Rule requirement for unanimous expert evidence or empirical evidence that current market estimates are above or below the upper or lower 95 per cent confidence interval in order that the currently available evidence be 'persuasive'. While these matters would be relevant to the persuasive value of the currently available evidence, whether that evidence is, in any given case, capable of persuading or inducing a belief, and thus 'persuasive', would turn on an assessment of all of the currently available evidence.

Finally, the Tribunal's decision establishes that evidence will constitute persuasive evidence justifying a departure from a previously adopted value where it discloses that the best estimate for the parameter value is far removed from that previously adopted. In so concluding, the Tribunal implicitly rejected any requirement for evidence proving the previously adopted value is 'incorrect'.

The Businesses acknowledge that, unlike clause 6.5.4(g) which explicitly refers to 'persuasive evidence justifying a departure ... from a value, method or credit rating level', clause 6.5.4(e)(4)(ii) does not explicitly specify the matter in respect of which persuasive evidence is required in establishing the persuasive evidence consideration applicable to WACC reviews. Nothing turns on this, however, as the persuasive evidence consideration in clause 6.5.4(e)(4)(ii) is properly construed as referring to persuasive evidence justifying a departure from a previously adopted value or method, or credit rating level.[342]

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determination of the AEMC under section 102 of the Law (see definition of 'final Rule determination' in section 2 of the Law). As the requirement to have regard to the persuasive evidence consideration established by clause 6.5.4(e)(4)(ii) is in substantively identical terms to the analogous requirement in clause 6A.6.2(j)(4)(ii), which was introduced following the 2006 TSNP Rule Determination, regard may properly be had to the 2006 TNSP Rule Determination in construing clause 6.5.4(e)(4)(ii) of Chapter 6.

[340] 2006 TNSP Rule Determination, p83.

[341] 2006 TNSP Rule Determination, p86.

[342] This conclusion necessarily follows from construing clause 6.5.4(e)(4)(ii) and the persuasive evidence consideration in accordance with:

- the 'cardinal rule of statutory interpretation', by reading it in its surrounding context, including in particular the explicit reference in clause 6.5.4(g) to 'persuasive evidence justifying a departure ... from a value, method or credit rating level'; and
- the intended purpose and meaning of the persuasive evidence consideration as disclosed in the AEMC's 2006 TNSP Rule Determination and 2006 TNSP Draft Rule Determination, both of which refer, in describing the consideration (at p83 and p58 respectively), to evidence that 'justif[ies] a change from the value adopted in the last review'.

The 'cardinal rule of statutory interpretation' is that the words of a provision of a statutory instrument be read in their context: *K&S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd* (1985) 60 ALR 509 at 514. See also Pearce and Geddes, *Statutory Interpretation in Australia*, 7th Edition at [4.2] for an exposition of this principle of statutory interpretation. Consideration may be given to the AEMC's 2006 TNSP Rule Determination and 2006 TNSP Draft Rule Determination in construing clause 6.5.4(e)(4)(ii) for the reasons

It therefore follows that the Tribunal's conclusions regarding what constitutes persuasive evidence justifying a departure from a previously adopted value are equally applicable to the persuasive evidence consideration to which regard must be had in WACC reviews. It, in turn, follows that the term 'persuasive evidence', properly construed, is not limited to evidence that proves the previously adopted parameter is 'incorrect'.

If the AEMC forms the view, despite the above, that the persuasive evidence consideration is of uncertain meaning and effect, the Businesses submit that the language of the persuasive evidence requirement should be amended to address any ambiguity, rather than be removed and replaced with a requirement to have regard to previously adopted values or methodologies, or credit rating levels as proposed by the AER.

Effect of 'persuasive evidence' requirement in WACC reviews on AER's ability to determine efficient benchmark rate of return

The existing persuasive evidence requirement has not operated in practice to 'restrict the AER's ability to determine an efficient benchmark rate of return'.

The outcomes of the 2009 WACC Review disclose that the existing requirement for the AER to have regard to the need for persuasive evidence did not operate, in practice, to prevent the AER from adopting parameter values that departed from those previously adopted where the AER considered different values were appropriate. As disclosed in the following table, the AER adopted parameter values that departed from those previously adopted in three instances, namely for the equity beta, MRP, and gamma.

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discussed in footnote 339 above and because the 2006 TNSP Draft Rule Determination is 'Rules extrinsic material' as defined in clause 8(1) of Schedule 2 to the Law, being a draft Rule determination of the AEMC under section 99 of the Law (see definition of 'draft Rule determination' in section 2 of the Law).

WACC parameter	SORI value[343]	Value previously adopted[344]	SORI departed from value previously adopted?
Nominal risk free rate	Moving average basis from the annualised yield on Commonwealth Government bond with maturity of 10 years	Moving average basis from the annualised yield on Commonwealth Government bond with maturity of 10 years	×
Equity beta	0.8	1.0 (TNSPs, Vic, NSW and ACT DNSPs) 0.9 (QLD, Tas and SA DNSPs)	✓
Market risk premium	6.5%	6%	✓
Debt to equity ratio	0.6	0.6	×
Credit rating level	BBB+	BBB+	×
Assumed utilisation of imputation credits (gamma)	0.65	0.5	✓

Table 5 - Parameter Values Adopted in 2009 WACC Review

In departing from parameter values previously adopted, the AER adopted a construction of the persuasive evidence requirement that is broadly consistent with the construction described above.[345] While stakeholders may have advocated for a different construction before the AER, neither the AER's construction of the requirement nor its decision to depart from the previously adopted values for three of the six parameter values more generally was the subject of any application for judicial review.

The Businesses acknowledge, however, the AER's concern that a requirement for persuasive evidence before departing from a previously adopted credit rating level, or value for, or method of calculating, a parameter in a WACC review of the kind proposed by the Businesses may operate to 'restrict the AER's ability to determine an efficient benchmark rate of return'. Rather than removing any requirement for persuasive evidence in WACC reviews from the Rules, however, the Businesses contend that this concern should be addressed by an amendment to the Rule provisions governing the application of WACC review outcomes in distribution determinations.

The Businesses observe that, as the parameter values for the risk free rate and DRP are determined only in making individual distribution determinations, any consideration of the overall rate of return can only occur in the making of a distribution determination and not before. The Businesses propose, therefore, that:

- the AER be required to determine on an overall rate of return to apply in a distribution determination that reflects the return required by investors in a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the DNSP; and

[343] 2009 SORI, p7.

[344] 2009 SORI Decision, ppv, 13.

[345] 2009 SORI Decision, pp82-92.

- to the extent of any inconsistency, this requirement prevail over the existing Rule requirement for persuasive evidence justifying a departure in that determination from a value, method or credit rating level set in an applicable WACC review.

The Businesses observe that the AER's justification of the removal of the persuasive evidence requirement on the basis that this 'will provide more flexibility for the AER to deal with changing market circumstances'[346] is difficult to reconcile with the AER's stated rationale for the proposed removal of the (limited) scope to revisit WACC review outcomes in making distribution determinations, namely that 'new information or theory ... is slow to evolve'.[347] In any event, the retention of a persuasive evidence requirement in the modified form proposed by the Businesses would not preclude flexibility to revisit parameter values in light of changed market conditions (recognised by the Businesses in section B.1 above as necessary). The proposed persuasive evidence requirement would require only that the AER have robust evidence of those changed market conditions and their implications for parameter values before varying those values.

The Businesses presume that the AER's proposed removal of the existing persuasive evidence requirement in WACC reviews is not premised on any concern with having a robust evidentiary basis for its view as to the appropriate credit rating level, parameter values or methods. Accordingly, the Businesses anticipate that amendments of the kind discussed above would suffice to address the AER's concerns.

Summary

The Businesses consider that, given the importance of having a robust evidentiary basis before departing from a previously adopted value or method, or credit rating level in a WACC review, the persuasive evidence requirement applicable to WACC reviews should be in the nature of a 'test' or 'threshold'. Such a requirement would ensure that the AER, in undertaking WACC reviews, has a robust evidentiary basis before departing from a previously adopted value or method, or credit rating level. This, in turn, would contribute to the certainty and predictability of the return on network investment that is important for the creation of incentives for, and the promotion of, efficient investment and, thus, the achievement of the NEO and the RPP set out in section 7A(3) of the Law.

By contrast, the existing Rule requirement to 'have regard to' the need for persuasive evidence has limited scope to deliver the certainty, predictability and historical consistency in WACC outcomes and is less effective in contributing to the achievement of the NEO and the relevant RPP. Accordingly, the Businesses propose that, rather than amending the Rules to remove the existing persuasive evidence requirement applicable to WACC reviews, the AEMC should amend the Rules to require that the AER not adopt a credit rating level, or a value for, or method of calculating, a parameter that differs from that previously adopted unless there is persuasive evidence justifying that departure.

The AER's proposed Rule change, including in particular its proposed requirement to have regard to previously adopted values or methodologies, or credit rating levels, would not suffice to deliver the historical consistency, regulatory certainty and predictability, and robust evidentiary basis for departures from previously adopted values or methods, or credit rating levels in WACC reviews that is so essential to the creation of incentives for, and promotion of, efficient network investment. As such, it will not promote the NEO and the relevant RPP relative to either the existing Rule

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[346] AER Rule Change Proposal, p20.

[347] AER Rule Change Proposal, p69.

requirement to have regard to the need for persuasive evidence or a requirement for persuasive evidence before any departure from a previously adopted credit rating level, or a value for, or method of calculating, a parameter of the kind proposed by the Businesses.

Accordingly, if (contrary to the submissions of the Businesses) the AEMC were to determine that the existing persuasive evidence requirement is of uncertain meaning and effect, the making of amendments to address any ambiguity in the language of the existing persuasive evidence requirement would better promote the NEO and the relevant RPP than the AER's proposed Rule change. In addition, while the Businesses acknowledge the AER's concerns that a persuasive evidence 'test' or 'threshold' of the kind proposed by the Businesses may restrict the AER's ability to determine an appropriate overall rate of return, the Businesses consider that this AER concern should be addressed by the imposition on the AER of a requirement to determine an appropriate overall rate of return in making distribution determinations that prevails over the existing Rule requirement for persuasive evidence justifying any departure in that determination from WACC review outcomes to the extent of any inconsistency.

B.3 TIMING OF WACC REVIEWS

AER Proposed Rule Change

Current Rule provisions

Under Chapter 6, the first WACC review was to be concluded by 1 May 2009 and further reviews are required to be concluded at intervals not exceeding five years with the first interval starting from 31 March 2009.[348] Under Chapter 6A, the AER was also to conclude the first WACC review by 1 May 2009 but is to conclude further reviews at intervals of five years with the first interval starting from 31 March 2009.[349] There is no scope, under Chapter 6A, for the AER to conduct WACC reviews at intervals shorter than five years.

AER's characterisation of 'the problem'

The AER is concerned that the current Rules may give rise to 'inconsistency with respect to the timing of reviews that apply for TNSPs and DNSPs'.[350] So, for example, if the AER considered it necessary to initiate a WACC review under Chapter 6 within a five year interval, the obligation to conduct the WACC review under Chapter 6A at the five year interval would result in 'the AER inappropriately delaying its review under chapter 6, or duplicating its efforts (and potentially the efforts of other stakeholders) within a short period of time'.[351] The AER further considers that 'the ability to commence a WACC review earlier than but at least once every five years, as per Chapter 6, is preferable'.[352]

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[348] Clause 6.5.4(b) of the Rules.

[349] Clause 6A.6.2(g) of the Rules.

[350] AER Rule Change Proposal, p75.

[351] AER Rule Change Proposal, p75.

[352] AER Rule Change Proposal, p76.

AER's proposed Rule changes

The AER proposed Rule changes amend Chapters 6 and 6A of the Rules to provide that a review is to be conducted by 1 March 2014 with further reviews to follow at intervals not exceeding five years.[353] The AER states that this will 'allow the AER to commence a WACC review concurrently for all electricity NSPs prior to a five year interval, and removes the possibility that different WACC reviews could be undertaken at different times for different sectors'.[354]

Businesses' Response

The Businesses agree with the alignment of the timeframe for WACC reviews under Chapters 6 and 6A of the Rules for the reasons discussed in section B.1 above. Further, the Businesses do not object to achieving this alignment by providing for WACC reviews under Chapters 6 and 6A to be conducted at intervals less than five years but observe that the potential detrimental effect of this on regulatory certainty would be ameliorated by enshrining criteria in the Rules for the exercise of the AER's discretion to conduct such an earlier WACC review. This, in turn, would better promote efficient investment and, thus, better contribute to the achievement of the NEO and the RPPs, than the AER's proposed Rule changes.

B.4 DEFINITION OF RETURN ON DEBT

AER and EURCC Rule Change Proposals

Current Rule provisions

Chapters 6 and 6A of the Rules define the return on debt to be the nominal risk free rate plus the DRP.[355]

The Rules define the DRP for a regulatory control period to be the premium determined for that period by the AER as the margin between the annualised nominal risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a maturity equal to that used to derive the nominal risk free rate and, in the case of Chapter 6, a credit rating from a recognised credit rating agency and, in the case of Chapter 6A, a BBB+ credit rating from Standard and Poors.[356] The Rules' definition of the risk free rate provides that the maturity used to determine that rate is 10 years.[357]

The maturity used to derive the nominal risk free rate and, thus, the DRP, and the credit rating level used to determine the DRP, may be revisited by the AER in a WACC review.[358] The DRP may not otherwise form the subject of a WACC review.

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[353] AER Draft Rules, pp20, 81 (proposed clauses 6.5.4(b), 6A.6.2(d)).

[354] AER Rule Change Proposal, p76.

[355] Clauses 6.5.2(b), 6A.6.2(b) of the Rules.

[356] Clauses 6.5.2(e), 6A.6.2(e) of the Rules.

[357] Clauses 6.5.2(c), 6A.6.2(c) of the Rules.

[358] Clauses 6.5.4(d), 6A.6.2(i) of the Rules.

The Rules provide that, in undertaking a WACC review, the AER must have regard to (amongst other things):[359]

- the need for the rate of return to be a forward looking rate of return that is commensurate with prevailing conditions in the market for funds;
- the need for the return on debt to reflect the current cost of borrowings for comparable debt; and
- the need for the credit rating levels, and values of or methods of calculating parameters, to be based on a benchmark efficient NSP.

In the 2009 SORI, the AER set the credit rating to BBB+ and affirmed the 10-year term to maturity for the nominal risk free rate.

AER characterisation of 'the problem' and proposed Rule changes

The AER contends that the definition of the DRP in the current Rules constrains its ability to set an efficient cost of debt which is consistent with the NEO and the RPPs. In particular, it asserts that 'the reference to a benchmark bond with a particular term to maturity, credit rating level and domicile of the issuer bears little resemblance to the financing practices of NSPs and other behaviours of NSPs to minimise their cost of debt'.[360]

The AER identifies three specific concerns with the existing definition of the DRP in the current Rules.

First, the AER asserts that, while the Rules' definition of the rate of return implies that the cost of debt should reflect that of 'a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the [network] business of the provider'[361], the yield on 'observed annualised Australian benchmark corporate bond[s]' with a particular credit rating and maturity may not fully reflect the risks of this benchmark provider.[362]

The AER contends that observed corporate bond yields are affected by factors other than credit rating and term to maturity.[363] Further, the AER observes that the Tribunal has recently concluded, in *Application by Jemena Gas Networks (NSW) Ltd (No 5)*, that the reference to 'observed annualised Australian benchmark corporate bond rates' with a particular credit rating and maturity in the current Rules' definition of the DRP necessitates consideration of bonds across all industry types in estimating the DRP and not just those classified as infrastructure bonds.[364] The AER contends that, as a result of this Tribunal decision, the cost of debt would only reflect that of 'a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the [network]

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[359] Clauses 6.5.4(e)(1)-(3), 6A.6.2(j)(1)-(3) of the Rules.

[360] AER Rule Change Proposal, p77. See also p17.

[361] Clauses 6.5.2(b), 6A.6.2(b) of the Rules.

[362] AER Rule Change Proposal, p77.

[363] AER Rule Change Proposal, p77.

[364] [2011] ACompT 10, [74].

business of the provider' and, thus, be consistent with the NEO and the RPPs, if the costs of debt for an efficient NSP are consistent with the costs of debt for the market generally.[365]

Secondly, while conceding that the existing Rules' definition of the DRP reflected market conditions and resultant practices in DRP estimation at the time Chapter 6A was drafted, the AER contends that the existing Rules' definition of the DRP means it lacks the required flexibility to adapt estimation practices to changes in debt markets and resultant changes in benchmark financing structures. The AER asserts that, as a consequence of the changes in debt markets post-dating the drafting of Chapter 6A, it is extremely difficult in prevailing market conditions to identify bonds that satisfy or even approximate 'observed annualised Australian benchmark corporate bond[s]' with a BBB+ credit rating and 10 year maturity (being the credit rating level and maturity used to derive the nominal risk free rate determined in the 2009 SORI). Alternative approaches based on comparisons of fair value curves published by Bloomberg and CBASpectrum have also been affected by data paucity issues. This has, in turn, resulted in continual debate regarding estimation methodologies and a focus on an examination of bonds with particular credit rating levels and maturities that has detracted from consideration of the efficient cost of debt for regulated NSPs.[366]

Thirdly, the AER contends that, as a consequence of the above, the benchmark DRP set by the AER in recent determinations has been significantly above NSPs' actual costs of debt. Whereas information from market reports discloses that the cost of recently issued debt for regulatory electricity network and gas pipeline businesses has been on average approximately 2.4% above the risk free rate, the AER has determined DRP values of between 3 and 4% in gas and electricity determinations since the beginning of 2010.[367]

For these reasons, the AER contends that the definition and methodology of estimation of the DRP should be determined in a WACC review or, if the DRP is to be prescribed in the Rules, there should be greater guidance on how it is to be set.[368]

Accordingly, the AER proposes Rule changes to remove the existing Rules' definition of the DRP[369] and provide for the DRP to form the subject of WACC reviews[370]. The AER proposes that its proposed SOCC will set out the definition and methodology for estimation of the DRP and thus prescribe that definition and methodology for the purposes of transmission and distribution determinations to which that SOCC is applicable.[371]

EURCC characterisation of 'the problem' and proposed Rule changes

The EURCC contends that, under the current Rules, there have been excessive returns to NSPs and inefficient overinvestment and excessive growth in the RAB.

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[365] AER Rule Change Proposal, p79.

[366] AER Rule Change Proposal, pp78-79.

[367] AER Rule Change Proposal, pp79-80.

[368] AER Rule Change Proposal, p78.

[369] AER Draft Rules, pp20, 81.

[370] AER Draft Rules, pp20-21, (proposed clauses 6.5.4(d), 6A.6.2(f)).

[371] AER Rule Change Proposal, p81.

The EURCC observes that an allowed return on debt above the actual cost of debt will translate into substantial increases in regulated revenues and, thus, network charges.[372] It maintains that the return on debt allowed in recent AER determinations has significantly exceeded regulated NSPs' actual costs of debt, which has, in turn, delivered excessive profits to regulated NSPs.[373] The EURCC further asserts that this margin between the allowed return on debt and the actual cost of debt has created incentives for inefficient over-investment by NSPs.[374]

The EURCC contends that these outcomes are a consequence of the existing Rules' definition of the DRP in that that definition specifies the 'wrong' benchmark, namely the yield on 'observed annualised Australian benchmark corporate bond[s]' with a particular credit rating and maturity, and precludes consideration of the actual cost of debt.[375]

The EURCC considers the benchmark established by the existing DRP definition is problematic because there were no corporate bonds issued in Australia with the requisite tenure and credit risk at the time of the AER's determinations and there are concerns regarding alternative approaches based on comparisons of fair value curves published by Bloomberg and CBASpectrum. In addition, the measurement of the DRP and risk free rate over a short averaging period in proximity to the start of the regulatory control period is said to be problematic because both elements of the return on debt vary significantly over short periods.[376]

The EURCC further contends that, while the Rules require that the AER, in undertaking a WACC review, have regard to 'the need for the return on debt to reflect the current cost of borrowings for comparable debt'[377], the definition of the DRP effectively precludes the AER from having regard to the actual cost of debt.[378]

In contrast to the AER, the EURCC considers that the methodology for estimation of the return on debt should be specified in the Rules and not left to the AER's regulatory discretion.[379] The EURCC proposes that the Rules be amended to specify that the return on debt be estimated using:[380]

- 5 year rather than 10 year maturity debt, so as to reflect current NSP practice;
- all broad BBB and A rated corporate debt issued in Australia, so as to ensure a more liquid market of bonds to establish the benchmark; and

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[372] EURCC Rule Change Proposal, p19.

[373] EURCC Rule Change Proposal, pp20-22.

[374] EURCC Rule Change Proposal, pp22-23.

[375] EURCC Rule Change Proposal, p24.

[376] EURCC Rule Change Proposal, pp24-27.

[377] Clauses 6.5.4(e)(2), 6A.6.2(j)(2) of the Rules.

[378] EURCC Rule Change Proposal, pp27-28.

[379] EURCC Rule Change Proposal, pp45-48.

[380] EURCC Rule Change Proposal, pp42-43.

- a five year trailing average return on debt pursuant to which the cost of debt is mechanistically updated in each regulatory year of the regulatory control period by reference to a simple average of the historical yield to maturity for broad BBB and A rated corporate bonds issued in Australia in the five year period ending on 31 December in the previous year.

In addition to proposing Rule changes that define the cost of debt so as to give effect to this proposal[381], the EURCC also proposes amendments to:[382]

- remove the maturity and credit rating levels used in estimating the cost of debt from the scope of WACC reviews; and
- remove from the considerations to which the AER must have regard in conducting WACC reviews those considerations providing for a forward-looking rate of return commensurate with prevailing conditions in the market for funds and a return on debt that reflects current borrowing costs, as these considerations are inconsistent with the backward-looking approach to the estimation of the return on debt proposed by the EURCC.

The EURCC foreshadows the need, but does not propose drafting, for consequential amendments to give effect to an annually varying cost of capital.[383]

Businesses' Response

The Businesses' response to the AER and EURCC Rule Change Proposals discusses, in turn, below:

- the Businesses' current actual debt financing practices;
- the implications of the NEO and relevant RPPs for the estimation of the cost of debt having regard to these current practices;
- the criteria that the Businesses contend should be adopted by the AEMC for the purposes of assessing any Rule change in relation to the cost of debt;
- the Businesses' views regarding 'the problems' with the current Rule provisions including its views on the AER's and EURCC's characterisation of those problems;
- the Businesses' assessment of the AER Rule Change Proposal including in particular against these criteria;
- the Businesses' assessment of the EURCC Rule Change Proposal including against these criteria; and
- the Businesses' views on the preferable Rule changes to address 'the problems' identified by the Businesses and the Businesses' resultant alternative Rule change proposal including in particular an assessment of that proposal against the proposed assessment criteria.

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[381] EURCC Rule Change Proposal, pp50-51 (proposed clauses 6.5.2(b), 6.5.2(e)).

[382] EURCC Rule Change Proposal, pp52-53 (proposed deletion of clauses 6.5.4(d)(4), 6.5.4(d)(6), 6.5.4(e)(1)-(3)).

[383] EURCC Rule Change Proposal, p53.

The Businesses' actual debt financing practices

An understanding of the NSPs' current approach to financing and managing interest rate risk is essential for any proper assessment of the AER and EURCC Rule Change Proposals. Accordingly, before proceeding to respond to those Proposals, this Response first explains the Businesses' current actual debt financing practices.

It is not prudent, or even possible for the Businesses to refinance their entire debt portfolio and/or to fund new capex requirements during the averaging period used to estimate the risk free rate for the AER's determinations. In addition, entering into financing arrangements outside the averaging period and for terms that vary from those utilised by the AER in estimating the allowed WACC creates substantial risk for the Businesses.

Therefore, to manage risk to an acceptable level, the Businesses implement treasury risk management strategies that aim to lock in fixed interest rate swaps averaged over the averaging period for both the existing level of debt and the forecast new debt requirements. As the interest rate swaps have a maturity date that matches the end of the regulatory control period, the Businesses hedge a substantial portion of their interest rate risk that arises under the regulated cost of debt in the WACC.

The Businesses take a prudent approach to raising debt financing by allowing the Businesses to issue debt with a tenure longer than the regulatory control period and to issue at times outside of the averaging period. The Businesses retain the debt margin risk and seek to manage this risk by diversifying the timing of debt issuances and the debt maturity dates.

The Businesses then carry a risk between the locked in fixed swap rate and the actual cost of the debt funding. The Businesses typically raise variable rate funding and hence the fixed credit margin over variable interest rate (the 'debt margin') is the margin at risk. The Businesses cannot hedge the debt margin.

In summary, the outcome of the interest rate risk management strategy is funding via longer term variable rate debt with the underlying interest rate fixed each five years at the time of the averaging period.

In respect of the debt funding, it is not prudent for the Businesses to issue short dated (five year) debt. Issuing five year debt results in the Businesses having $1/5^{th}$ of debt maturing each year which substantially increases the Businesses' refinancing risk, impacting the credit rating and consequently the cost of funds of the Businesses. In addition, the debt margin will increase as a five year tenure limits the available funding sources.

During the 2009 WACC review, four privately owned NSPs provided the AER with a breakdown of their full debt portfolios on a confidential basis.[384] The average term at issuance was slightly over ten years.

Table 6 below provides details of the total outstanding debt of the Businesses as at November 2011. The weighted average term to maturity is 9.3 years.

[384] 2009 SORI Decision, p164.

Entity name	Start date	Maturity Date	Term	AUD$M Equiv.	Type of debt
CitiPower	Feb-03	Feb-13	10.0	300	Wrapped FRN
CitiPower	Jan-07	Jul-17	10.5	575	Wrapped FRN
CitiPower	Sep-09	Feb-13	3.5	175	Bank Debt
CitiPower	Sep-11	Sep-14	3.0	200	Bank Debt
Powercor Australia	Nov-05	Nov-15	10.0	200	Wrapped FRN
Powercor Australia	Aug-07	Aug-21	14.0	300	Wrapped FRN
Powercor Australia	Aug-07	Jan-22	14.4	630	Wrapped FRN
Powercor Australia	Nov-09	Nov-14	5.0	109	USPP USD$100m
Powercor Australia	Nov-09	Nov-16	7.0	191	USPP USD$175m
Powercor Australia	Dec-10	Dec-14	4.0	250	Syndicated Bank Debt
Powercor Australia	Apr-11	May-16	5.1	144	USPP USD$150m
Powercor Australia	Apr-11	Jun-18	7.2	351	USPP USD$365m
Powercor Australia	Apr-11	Jun-20	9.2	178	USPP USD$185m
ETSA Utilities	Nov-04	Oct-16	11.9	265	USPP USD$192m
ETSA Utilities	Nov-04	Oct-19	14.9	269	USPP USD$195m
ETSA Utilities	Jul-05	Jul-15	10.0	300	Wrapped FRN
ETSA Utilities	Apr-07	Apr-18	11.0	350	Wrapped FRN
ETSA Utilities	Apr-07	Oct-19	12.5	300	Wrapped FRN
ETSA Utilities	Sep-09	Sep-14	5.0	125	USPP USD$100m
ETSA Utilities	Sep-09	Sep-14	5.0	78	USPP USD$62.5m
ETSA Utilities	Sep-09	Sep-16	7.0	106	USPP USD$84.5m
ETSA Utilities	Sep-09	Sep-16	7.0	116	USPP USD$93m
ETSA Utilities	Sep-09	Sep-19	10.0	200	USPP USD$160m
ETSA Utilities	Apr-10	Apr-13	3.0	225	Bank debt
ETSA Utilities	Mar-11	Sep-16	5.5	250	FRN

Table 6 - Total outstanding debt of CitiPower, Powercor Australia and ETSA Utilities as at November 2011

The GFC has resulted in the Businesses raising debt with a shorter term to maturity as evidenced in Table 6 above with debt issued since 2008 having a weighted average term to maturity of 5.8 years. This is a result of the lack of a credit enhanced market and an investor preference (including banks) for shorter dated maturities.

Post the GFC and the current global concerns in financial markets, the Businesses would expect, in fact prefer, to issue longer tenure debt (i.e. 10 years plus) again.

Assuming normal financial market conditions, the Businesses would issue debt on average with a tenure of 10 years. Assuming the Businesses issued 1/10th of the debt each year, the Businesses will have a backward looking and forward looking cost of debt at the time of the averaging period used in the AER's determinations. On a rolling basis lagged by a year, the Businesses would have a known debt margin over swap, hence a backward looking debt margin over swap.

In addition to managing interest rate risk, the Businesses' treasury risk management policies require the Businesses to manage liquidity risk and hence refinancing risk. These treasury policies require that the Businesses' debt funding requirements are committed, underwritten or fully funded at least six months prior to the requirement for refinancing; that is prior to the maturity of any debt facility. This not only ensures that the refinancing risk is minimised, but also ensures that the Businesses do not experience any adverse credit rating impact arising from the failure to have funding in place given that credit rating agencies expect that refinancing arrangements will be in place substantially in advance of the maturity date.

The Businesses incur costs associated with ensuring debt funding is committed, underwritten or fully funded in advance of a refinancing requirement. A statement of Julie Marie Williams dated 19 August 2010, provided to the AER on the same date in the course of the Victorian Distribution Determinations process and attached to this Response as Attachments 32 and 32C, provides further details of the cost to the Businesses of the prudent management of refinancing risk.

As an example of early refinancing costs, ETSA issued bonds some six months prior to enable repayment of the majority of its April 2010 $750 million debt financing. This was done so as to minimise refinancing risk and assist in maintaining its quality credit rating – thereby lowering the interest otherwise payable on borrowings. A small portion of the funds from the bonds issued were used to repay April 2010 maturing notes early. However, the majority was placed on term deposit until the notes matured at a holding cost of slightly more than 2 percent for the six month period (measured as the difference between the interest rate payable on the borrowing and that earned on the term deposit).

Estimation of a benchmark return on debt using a backward looking debt margin and forward looking swap rate best contributes to achievement of the NEO and relevant RPPs

The incentive properties of the NEO preclude the use of the actual return on debt to determine network charges. Therefore, a benchmark approach must be used to determine network charges.

Since the AER approach to date has been to set a forward looking return on debt, but the EURCC proposes that the Rules be amended to prescribe a backward looking benchmark trailing return on debt, it is instructive to examine which is more consistent with the NEO and RPPs, which govern the AEMC's consideration of the AER and EURCC Rule Change Proposals[385].

In *Application by Energy Australia and Others*[386], the Tribunal discussed the implications of the NEO and the RPPs relevant to the return on debt, being that an NSP should be provided with a reasonable opportunity to recover at least its efficient costs and effective incentives for efficient investment[387], for the estimation of the WACC. In discussing the regulatory framework generally,

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[385] Sections 88, 88B of the Law.

[386] [2009] ACompT 8.

[387] Sections 7A(2)-(3) of the Law.

the Tribunal stated as follows regarding these implications of the NEO and the RPPs for WACC estimation:[388]

> The national electricity objective provides the overarching economic objective for regulation under the NEL: the promotion of efficient investment and efficient operation and use of, electricity services for the long term interests of consumers. Consumers will benefit in the long run if resources are used efficiently, that is if resources are allocated to the delivery of goods and services in accordance with consumer preferences at least cost. **As reflected in the revenue and pricing principles, this in turn requires prices to reflect the long run cost of supply and to support efficient investment, providing investors with a return which covers the opportunity cost of capital required to deliver the services.**
>
> [Emphasis added in bold.]

In discussing the averaging period for the risk-free rate, the Tribunal further stated regarding these implications:[389]

> The Transitional Rules provide the context for the proposing of an averaging period, but the proposal must be in accordance with the NEL, and more specifically with the national electricity objective and the revenue and pricing principles set out in s 7 and s 7A, respectively.
>
> The principles in s 7A can be taken to be consistent with and to promote the objectives in s 7. The principles are themselves stated normatively in the form of what is intended to be achieved. They state that the price charged by a Network Service Provider ('DNSP') for its service should allow a return commensurate with the regulatory and commercial risks involved in providing the service in the context that the DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs and with effective incentives in order to promote economic efficiency with respect to the services it provides. Economic efficiency includes efficient investment in the system with which it provides services, efficient provision of services, and efficient use of the system.
>
> It is well accepted in the literature of regulatory economics and in regulatory practice that all these efficiency objectives are in principle met by setting prices for services that allow the recovery of efficient costs, including the cost of capital commensurate with the riskiness of the investment in the assets (infrastructure or 'system', as the term is used in the NEL) used to provide services.
>
> It might be asked why the NEL principles require that the regulated DNSP be provided with the opportunity to recover at least its efficient costs. Why 'at least'? The issue of opportunity is critical to the answer. The regulatory framework does not guarantee recovery of costs, efficient or otherwise. Many events and circumstances, all characterised by various uncertainties, intervene between the ex ante regulatory setting of prices and the ex post assessment of whether costs were recovered. But if, as it were, the dice are loaded against the DNSP at the outset by the regulator not providing the opportunity for it to recover its efficient costs (eg, by making insufficient provision for its operating costs or its cost of capital), then the DNSP will not have the incentives to achieve the efficiency objectives, the achievement of which is the purpose of the regulatory regime.
>
> Thus, given that the regulatory setting of prices is determined prior to ascertaining the actual operating environment that will prevail during the regulatory control period, the regulatory framework may be said to err on the side of allowing at least the recovery of efficient costs. This is in the context of no adjustment generally being made after the event for changed circumstances.

In summary, the Tribunal concluded that, if an NSP is not provided with a reasonable opportunity to recover at least its efficient costs, it will not have incentives to achieve the efficiency objectives of the NEO and the relevant RPPs.

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[388] [2009] ACompT 8, [18].

[389] [2009] ACompT 8, [78]-[82].

This Response demonstrates that the current refinancing and hedging practice of most privately-owned NSPs exposes those NSPs to a rolling backward looking debt margin over swap but a forward looking swap rate. Therefore, it is specification by the Rules that the return on debt be estimated using a rolling backward looking benchmark debt margin over swap and forward looking swap rate that is most likely to contribute to the achievement of the NEO and the relevant RPPs.

If it is deemed that an element of the return on debt should be measured using a rolling backward looking benchmark approach, then a number of consequential Rule changes would be required. The AER does not have the power to make Rule changes, and neither would there be sufficient time for the AER to apply for a Rule change after determining on a backward looking benchmark method in either the next WACC review or a transmission or distribution determination. Therefore, it is appropriate that the AEMC make a decision on whether a rolling backward looking benchmark approach in relation to the debt margin ought to apply, and if so, to make the consequential Rule changes required.

Problems with the current Rules

The return on debt should reflect efficient NSP debt financing practices. As discussed above, this is required to contribute to the achievement of the NEO and the relevant RPPs, as the efficiency objectives of the NEO may not be achieved if an NSP is not provided with a reasonable opportunity to recover at least its efficient costs.

The Businesses understand that the Businesses' debt financing practices outlined above are not too dissimilar to those of other privately owned NSPs. Inconsistencies between actual debt financing practice of NSPs and the current Rules are as follows:

- The Rules contemplate that the return on debt should be forward looking[390], whereas an NSP's actual costs of debt are both backward and forward looking at the time of a determination.
- NSPs typically face different term exposures on the swap rate and debt margin over swap, but the Rules require the term to maturity of the risk free rate to also apply to the DRP.
- The Rules distinguish between the risk free rate and the DRP, whereas an NSP's cost exposure is to the swap rate and debt margin over swap.
- There is no explicit provision in the Rules for the recovery of other debt financing costs, including the following, which are incurred by a benchmark efficient NSP and are material:
    - Early refinancing costs;
    - Book build underwriting fees;
    - Legal, road-show, company credit rating, issue credit rating, registry fees and paying fees;
    - Costs of currency swaps and fixed for variable swaps depending on the debt issued; and

[390] Clauses 6.5.4(e)(1), 6A.6.2(j)(1) of the Rules.

- Interest rate hedges transacted during the averaging period used in estimating the risk free rate for the purposes of the AER's determinations.

However, the Businesses do not agree with the AER's and EURCC's contention that the divergence between NSPs' actual cost of debt and the return on debt allowed by the AER in recent determinations represents a problem with the existing Rules' definition of the DRP.

To assist in the Businesses' consideration of the AER and EURCC proposals concerning the cost of debt, the Businesses requested that CEG review the AER and EURCC analysis relating to the 'gap' between the actual DRP and that determined by the AER under the Rules and comment on any actual or implied implications of this for the reasonableness of the rates of return allowed by the AER under the current Rules. The resultant CEG DRP Rule Change Report is attached to this Response as Attachment 77.

The AER and EURCC conduct their analysis in the context of the actual forward looking DRP and not the embedded DRP. This is appropriate in the current context where the Rules contemplate that the return on debt should be forward looking.

In the CEG DRP Rule Change Report, CEG concludes that there is no evidence of a 'gap' between actual and benchmark WACC arising from the DRP because, in summary:

- The AER and EURCC only consider the return on debt in isolation and do not consider the effect on the return on equity of the recent change in NSP practice to issue shorter term debt. Modigliani and Miller, the Nobel Prize winning finance academics, demonstrated that changes in the financing structure will alter the cost of equity in an offsetting fashion. They demonstrated that, if we observe a dominant financing strategy, such as the issuing of long-term debt, then this must be because there are advantages to issuing long term debt, such as lessening exposure to refinance risk and potential insolvency and bankruptcy transaction costs. That is, if issuing long-term debt is a dominant strategy for particular kinds of businesses then it must be the case that issuing short-term debt raises the WACC, and hence raises the cost of equity by more than the reduction in the cost of debt.

- NSPs raised long term debt prior to the GFC, and have subsequently issued shorter term debt.

- Table 7.5 in the AER Rule Change Proposal included five recent debt issues by entities that are in part owned by the Government of Singapore (namely, SPI and SPIAA). The AER's own consultants have advised the AER that the debt premiums on such debt are depressed by the implicit government guarantee associated with this ownership structure.[391] Consistent with this, Table 7.5 of the AER Rule Change Proposal indicates that the DRP for these issues are all below the average, even though the average term to maturity is greater than the average. For this reason it is inappropriate to draw any conclusions based on the SPI and SPIAA issues.

- When the DRP for recent non-SPI actual bond issues are adjusted to a ten year DRP, more than half of the implied ten year DRPs are greater than the nearest regulatory allowance to that bond issue. This demonstrates that recent determinations of DRP (as amended by the

[391] Oakvale Capital, *Report on the cost of debt during the averaging period: The impact of callable bonds, Prepared for the Australian Energy Regulator*, February 2011, p24.

Tribunal) are a reasonable reflection of the actual Australian corporate bond ten year BBB+ DRP.

In summary, while there is a DRP 'gap', it is primarily a function of differences in the maturity period. The DRP 'gap' is expected to be more than offset by the return on equity 'gap' and therefore recent benchmark WACC determinations have not been compromised by the apparent DRP 'gap'.

Finally, the Businesses consider that the AER has overplayed the constraints imposed by the current Rules governing estimation of the cost of debt.

Discretion in setting the return on debt for DNSPs is constrained by:

- Those elements of estimation that are prescribed in the Rules, namely the Rule requirements prescribing that:
    - the return on debt is the sum of the nominal risk free rate and the DRP;
    - the DRP is the margin between the annualised nominal risk free rate and the observed annualised Australian benchmark corporate bond rate;
    - the bond rate is to be based on a credit rating from a recognised credit rating agency; and
    - the term to maturity for the nominal risk free rate and the DRP must be equal.
- Those elements of estimation which are the subject of the SORI, but which can be departed from in a distribution determination if there is persuasive evidence to do so, namely:
    - the method for determining the nominal risk free rate;
    - the credit rating level; and
    - the term to maturity for the nominal risk free rate and DRP.

The AER has overplayed the constraints imposed by the current Rules because those elements which are dealt with in the SORI, and which have been identified as the most constraining (being the credit rating and term to maturity), can be departed from if there is persuasive evidence to do so.[392]

Even if there is no persuasive evidence to depart from the term to maturity and credit rating in the SORI, the AER is not precluded from considering a range of data and other factors to determine the DRP.

Accordingly, while the Businesses agree with the AER and EURCC that the GFC has created difficulties in the measurement of the DRP under the Rules, thus resulting in debate before the AER and disputes before the Tribunal regarding DRP estimation, the Businesses consider the constraints on the AER's flexibility to address data availability issues by reason of the Rules are overstated by the AER.

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[392] CEG has demonstrated, in the CEG DRP Rule Change Report, that it would not have been appropriate to depart from the SORI, unless departures were also made in respect of return on equity.

For example, in the AER's *draft* decision for the Victorian DNSPs it had regard to just 5 bonds (all with maturity of less than 4.5 years). However, this was not because that was all the bonds available (as suggested by the EURCC). Rather, it was because the AER had unnecessarily and incorrectly restricted the sample that it would examine to fixed rate (i.e. excluding floating rate) BBB+ bonds (i.e. excluding A- and BBB rated bonds). This was precisely the same methodology that the AER had previously used in its ACT gas distribution decision for ActewAGL Distribution and which was subsequently successfully appealed by ActewAGL Distribution in the Tribunal[393].

In their revised regulatory proposals, the Victorian DNSP's provided a report from PwC indicating that the AER had failed to consider a wider range of data in its determination of the DRP as follows:[394]

> By restricting its attention only to the Bloomberg and CBASpectrum fair value curves and the limited number of BBB+ rated Australian corporate bonds on issue, the AER has ignored other potentially useful sources of information that may assist in improving the estimate of the debt risk premium that is 'commensurate with prevailing conditions in the market' for a 10 year BBB+ Australian corporate (fixed rate) bond. Its sole focus on Bloomberg and CBASpectrum is difficult to justify given the lack of transparency with which each of the services establish their debt risk premiums, explicit disclaimers associated with their estimates and for CBASpectrum a statement that it draws upon historical information and is focussed mainly on producing relative yield estimates and hence is not 'fit for purpose'. As we have stated previously, given the very limited number of BBB+ Australian corporate bonds on issue and the fact that none extend beyond a 6 year term we consider it appropriate to have regard to the debt risk premiums for bonds with other credit ratings, as well as floating rate bonds (converted to a fixed rate equivalent) in order to refine the estimate of the current required debt risk premium for a 10 year BBB+ Australian corporate (fixed rate) bond. In addition, we also consider it appropriate to have regard to other estimates of 'fair value' curves for Australian corporate bonds, and preferably one that is more transparent and fit for purpose.

The Victorian DNSPs also provided the AER with a report from CEG[395], which expressed similar concerns as follows:

> In the absence of a large number of bonds with those exact characteristics it is our view that the AER must have regard to any information that is relevant to estimating the yield on a 10 year fixed coupon bond. This would include information on:
>
> - BBB+ fixed coupon bonds issued by 'Australian' companies with maturities of less than 6 years (i.e. the AER sample);
> - BBB+ floating rate bonds with maturities closer to 10 years;
> - bonds with ratings other than BBB+ (including, in particular, such bonds with maturities close to 10 years and with credit ratings close to BBB+, such as BBB and A-);
> - Bonds issued by 'foreign' companies in Australia.

The Victorian DNSPs proposed a series of tests designed by PwC[396] to determine whether the Bloomberg or CBASpectrum fair value curves reasonably meet the Rule requirements for

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[393] *Application by ActewAGL Distribution* [2010] ACompT 4.

[394] PwC, *Methodology for the calculation of debt risk premium*, 19 July 2010, pp6-7.

[395] CEG, *Testing the accuracy of Bloomberg vs CBASpectrum Fair Value Estimates. A report for Victorian Electricity DBs*, July 2010, p22.

[396] PwC, *Methodology for the calculation of debt risk premium*, 19 July 2010.

determining the DRP. The AER chose not to apply these tests in its Victorian Distribution Determinations Final Decision.

It was only after the Tribunal, in *Application by ActewAGL Distribution*, found the AER was in error to exclude floating rate bonds and A- and BBB bonds and restrict itself to such a small sample of bonds[397] that the AER had regard to a wider sample.

Criteria for assessment of Rule changes

The Businesses consider that the criteria adopted by the AEMC for assessment of the proposed Rule changes should contribute to the achievement of the NEO and RPPs. The Businesses propose the following criteria:

1 Incentives for efficient investment

Taken directly from the NEO and RPPs.

2 Reasonable opportunity to recover at least efficient costs

Taken directly from the NEO and RPPs.

3 Flexibility to accommodate various market conditions and data availability

Due to the changing nature of debt market conditions and the shifting availability of market data and fair market curves, flexibility will allow a return on debt to be determined which balances the long term interests of consumers with the opportunity for NSPs to recover at least efficient costs.

4 Predictability so that an NSP can efficiently manage risks

The long term interest of consumers will not be served if the regulatory framework hinders an NSP's ability to efficiently manage risks. When refinancing debt, an NSP's decisions about the term of debt, and whether it is fixed or variable rate debt, are influenced by the method by which the debt benchmark is set. The strategy could be very different depending on whether each of the risk free rate and DRP are set based on a short averaging period close to the date of the final determination, or based on a longer term historical average.

5 No material increase in the level of risk associated with existing debt

Most privately owned NSPs have issued variable rate debt overlayed with interest rate swaps entered into during the averaging period and for a term of equivalent length to the regulatory control period. This behaviour is driven by how the regulatory return on debt allowance has been set under the current Rules. Any change in the Rules needs to consider the nature of existing debt raised by an efficient NSP under the current Rules and how a change in Rules could affect the risks borne by an efficient NSP in the future. As an example, the Businesses have existing long dated debt, e.g. Powercor Australia has $630 million of variable rate debt maturing in 2022 and ETSA Utilities has $770 million of variable rate debt maturing in 2019.

[397] [2010] ACompT 4, [58], [63], [73]-[77].

6 Transparency

To allow all stakeholders to properly assess the methodology and the application of that methodology, in order to determine that the return on debt reflects at least efficient costs.

Assessment of AER Rule Change Proposal

As the AER proposes to remove the definition of DRP and nominal risk free rate from the Rules and provide for the AER to determine either their values or methods in a WACC review, the AER Rule Change Proposal confers substantially increased discretion on the AER and is likely to lead to increased disputes. The AER has failed to illustrate how a substantial increase in discretion will lead to better decision making. Its own analysis supporting its proposed Rule change is at best superficial.

The AER's proposed Rule change also performs poorly when assessed against the criteria proposed by the Businesses for assessment of Rule changes relating to the definition of the cost of debt, as follows:

1 Incentives for efficient investment

There is a risk that this criterion would not be satisfied because the AER:

- may select a term of debt which implies higher refinancing risk relative to that in the period in which the equity beta is determined. This will under-compensate the NSP in the short term, and potentially encourage inefficient debt financing practices which will lead to higher regulated WACCs in the longer term. This concern is based on the recognition by the AER in the AER Rule Change Proposal of the impact of lower debt maturities on the cost of debt but not on the cost of equity, in asserting that the observed divergence between NSPs' actual DRPs and the DRPs allowed by the AER demonstrate an inappropriate overall rate of return in AER determinations;
- discretion will result in a high level of uncertainty, thus hampering efficient investment;
- has not included a reasonable allowance for early refinancing costs in past decisions and, with greater discretion and less accountability, it is unlikely to do so in the future; and
- would not be held accountable for its return on debt decisions as merits review is not available for WACC decisions made in a WACC review for the reasons explained in section B.1 above.

2 Reasonable opportunity to recover at least efficient costs

It cannot be known whether, in practice, the AER Rule Change Proposal would, if implemented, provide NSPs with a reasonably opportunity to recover at least their efficient costs of debt due to the uncertainty over how the AER would exercise its discretion. Assuming the AER continued to determine a forward looking return on debt, an efficient NSP would be exposed to windfall gains and losses due to the timing difference between the regulatory averaging period and the actual timing of debt issuance.

3 Flexibility to accommodate various market conditions and data availability

The AER Rule Change Proposal may not be sufficiently flexible to accommodate changing market conditions and data available issues, as the AER could lock in a methodology in the SORI, with the consequence that that methodology could not be departed from until the next WACC review. As discussed in section B.1 above, the changing market conditions and resultant data paucity issues giving rise to the AER's concerns with the existing Rules' definition of the DRP post-date the 2009 WACC Review disclosing that the review of a methodology for estimation of the DRP prescribed in the SORI at WACC reviews conducted at approximately 5 years intervals may not provide adequate flexibility. Flexibility should be provided by making the SORI methodology flexible, with the finalisation of the methodology occurring in the determination process.

4 Predictability so that an NSP can efficiently manage risks

The AER Rule Change Proposal is unlikely to provide the predictability necessary for an efficient NSP to manage its risks. When refinancing debt, NSPs' decisions about the term of debt, and whether it is fixed or variable rate debt, are influenced by the method by which the debt benchmark is set. Under the AER Rule Change Proposal, NSPs will not know how it will set the return on debt until the completion of its WACC review on 1 March 2014. Even then, it is not clear how much certainty that review will provide. By removing the flexibility in the current Rules to depart from the SORI under certain criteria, the AER would by implication determine a highly flexible method for determining the DRP and nominal risk free rate. This flexibility may not provide the predictability required so that a NSP can efficiently manage risks.

5 No material increase in level of risk associated with existing debt

Since the AER method for setting DRP is unknown, it is not known whether or not there will be a material increase in level of risk associated with existing debt.

6 Transparency

It is uncertain whether this criterion would be satisfied. However, since the AER could not be held accountable for its determinations on return on debt, there is a high risk that determinations will not be transparent.

In summary, the AER proposal does not satisfy most of the criteria.

Assessment of EURCC Rule Change Proposal

The Businesses have only assessed the EURCC Rule Change Proposal in respect of the return on debt issued to private lenders.

The EURCC proposes a five-year trailing average return on debt. The average is to be based on the simple average yield to maturity of A and broad BBB fair market value estimates of corporate bonds issued in Australia over the five year period ending on December 31st of the previous year. Implied changes from the current Rules are:

- the return on debt is not divided between the risk free rate and DRP, i.e. the proposal assumes issuance of fixed rate debt and includes a trailing average return on the total cost of debt;

- the return on debt is based on an average cost over a rolling prior 5 year period;
- a rolling average is to be determined for each year of the regulatory control period, thus necessitating an annual 'true-up' process;
- an explicit credit rating range of A and broad BBB is defined; and
- whilst the EURCC Rule Change Proposal states that a five-year term to maturity be used, its proposed draft Rule is silent on the term to maturity.

The EURCC proposal retains Australian corporate bonds as the benchmark.

The Businesses consider that the EURCC analysis of term to maturity of debt is flawed.

The EURCC proposes a five year backward rolling benchmark approach based on the recommendation of CEPA in the CEPA Report commissioned by the EURCC for the purposes of its proposal. CEPA evaluate a target maturity of ten years against five years and present the following to support their assertion that the remaining term to maturity of Australian network utility debt is just under five years:

- Table 4.6 indicates that the average remaining life of bond debt for privately owned networks is on average just under five years.
- Figure 4.1 presents the maturity profile[398] of Australian rated utility debt in 2011, and concludes that roughly 40% of debt has a remaining term to maturity of less than five years.
- Figure 4.2 presents the maturity profile of SP AusNet debt in 2011, and concludes that the majority of debt has a remaining maturity of under five years and very little at the ten year end.

CEPA conclude that:[399]

> This evidence suggests that the average age of debt is significantly below the 10 years specified in the NER for setting Return on Debt …This means that, currently at least, any approach to setting the allowed Return on Debt based on a 10 year maturity will not reflect how the companies structure their debt.

However, CEPA have confused the full term to maturity at the issue date with remaining term to maturity. The following illustrates the point:

- Assume that an NSP refinances 10 per cent of its debt annually. To maintain its debt at the same level it can only issue debt with a ten year term to maturity.
- At any point in time its maturity profile will be 10 per cent of debt for each year over the next ten years, but with an average remaining term to maturity of five years.

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[398] Whilst not stated explicitly, debt profile charts in the form of those shown in Figures 4.1 and 4.2 of the CEPA Report present remaining term to maturity. These charts are useful for the assessment of refinancing risk as they indicate whether a large amount of debt will need to be refinanced in any one year.

[399] CEPA Report, p17.

- As is common practice, the debt cost is calculated as a debt margin over swap which is fixed over the full term of the debt plus the variable swap rate. The fixed debt margin will reflect the perceived risk by lenders of their investment over the full ten year term of their investment.
- At any point in time, the NSP's cost of debt will be the current swap rate plus the average debt margin over the previous ten years, with each year's debt margin being the ten year premium.
- Whilst an NSP can fix the variable swap rate with interest rate swaps, it cannot alter the quantum of the fixed debt margins locked in over the last 10 years.
- However, CEPA have (incorrectly) assumed that the cost of debt will be the average cost of debt over the previous five years, with each year's cost of debt being a five year premium.

If a business issues 10-year debt on average, then it is not surprising that CEPA observes an average remaining term to maturity of five years. Table 7 presents the remaining term and full term of network bond issues calculated using the underlying data relied on and presented by CEPA.[400]

Company	Total Debt (AUD) m	No. of bonds issued	Remaining term		Full term	
			Average (yrs)	Weighted average (yrs)	Average (yrs)	Weighted average (yrs)
CitiPower	875.0	3	4.4	4.3	10.3	10.3
ETSA Utilities	850.0	3	5.6	5.7	9.3	9.5
Jemena Ltd	569.2	4	5.3	5.3	16.0	16.0
Powercor Australia	1,130.0	3	8.1	9.1	12.8	13.5
SPI Aust Fin Ltd	235.0	2	0.2	0.2	7.0	7.0
SPI Australia As	1,097.3	3	6.1	6.1	7.0	6.5
SPI Elect & Gas	2,605.3	9	5.0	4.9	8.9	8.8
United Energy	879.4	3	4.1	3.8	11.3	10.5
Total/Average	8,241.1	30	4.9	5.4	10.3	10.0

Table 7 - Maturity of network bond issues

Therefore, on the basis of CEPA's analysis, a backward looking benchmark approach should calculate a rolling average over the previous ten years, and should be based on a ten year DRP.

CEPA's evaluation of incentives of using a five-year term is: [401]

[400] CEPA Report, pp42-43. There are small differences in total debt and remaining term compared to Table 4.6 in the CEPA Report, presumably due to differences in exchange rate assumptions.

[401] CEPA Report, p19.

> Using five year bonds may create an incentive for companies to fund themselves with shorter maturity debt than would be expected. This could create a re-financing risk for companies and is a perverse outcome.
>
> Evidence shows that companies primarily use shorter dated AUD issues and so while this is a theoretically correct risk, it is unlikely to actually arise (or be significant if it does arise).

Given that CEPA's evidence that companies primarily use shorted dated AUD issues is flawed and companies actually primarily use longer dated AUD issues, the refinancing risk under their recommendation is material. CEPA have failed to consider the practicality of the DNSPs issuing their total debt to a term of five years (or shorter).

The CEPA analysis is also confused as it assumes the NSPs issue fixed rate debt thereby establishing the risk free rate and DRP to the maturity of the debt at the time of issuance. As discussed in an earlier section, it is common practice that the NSPs lock in interest rate swap hedges at the time of the average period used to estimate the risk free rate and DRP for the purposes of the AER's determinations, so as to fix the risk free rate and the margin to the swap rate over the risk free rate.

- At any point in time, the NSP's total cost of debt will be the sum of the risk free rate and the margin to swap as hedged at the time of the averaging period and the fixed debt margin being the ten year debt margin over swap established at the time of issuing the debt.
- CEPA have assumed that the total cost of debt will be the average cost of debt over the previous five years, with each year's cost of debt being a five year premium.
- The approach proposed by CEPA is not practical in that it cannot be implemented by the NSPs in practice and it results in the NSPs having a risk larger than what is accepted using their current practices. To implement the CEPA approach in practice, the NSPs would need to issue $1/5^{th}$ of their debt each year averaged over every day of the year i.e. 1/365 of the $1/5^{th}$ annual funding requirement each day. The risk accepted by an NSP if their actual funding differs from this averaged approach is large, as it is the total cost of debt that is being established every day over the five year period, i.e. it includes the risk free rate and the DRP.

Finally, the Businesses consider that the EURCC Rule Change Proposal performs poorly when assessed against the criteria proposed by the Businesses for assessment of Rule changes relating to the definition of the cost of debt, as follows:

1 Incentives for efficient investment

Assuming that efficient investment would only be promoted if NSPs had a reasonable opportunity to recover efficient costs, the EURCC proposal's performance against this criterion is mixed for the reasons discussed below in respect of criterion 2.

2 Reasonable opportunity to recover at least efficient costs

The backward looking rolling benchmark approach provides a reasonable opportunity for the NSP to recover a component of its efficient costs.

However, the following elements of the proposal do not provide a reasonable opportunity to recover at least efficient costs:

- The assumption that an efficient NSP would refinance 20 per cent of its total debt each year is incorrect and cannot practicably be achieved without

compromising the other WACC parameters, in addition to compromising its credit rating. Additionally, it does not take into account the significant increase in other debt costs such as early refinancing.

- Whilst the EURCC states that a five-year term to maturity be used, its proposed draft Rule is silent on the term to maturity. Either approach is problematic. If the EURCC intended the term to maturity to be five years, then this is would not be reflective of the term to maturity of an efficient NSP. If the EURCC intended the term to maturity to be the average of all Australian corporate bonds, then this would not be reflective of the term to maturity of an efficient NSP because NSPs are likely to issue longer term bonds relative to the average Australian corporate because NSPs have longer life assets and large debt requirements.

- In relation to the risk free rate, the NSP is effectively provided with an average risk free rate over the last 5 years. An NSP that issued fixed rate debt each day of the last 5 years would have a reasonable opportunity to recover its costs. However, previously it was outlined that efficient NSPs issue floating rate debt and that it is not practical for an NSP to implement such a funding arrangement.

3 Flexibility to accommodate various market conditions and data availability

The proposed Rules are sufficiently flexible to accommodate various market conditions and data availability.

4 Predictability so that an NSP can efficiently manage risks

The proposed Rules provide sufficient predictability for an NSP to efficiently manage risks on a forward looking basis.

5 No material increase in level of risk associated with existing debt

An efficient NSP would be exposed to new and very significant interest rate and refinancing risks, as outlined above.

6 Transparency

The proposed Rules facilitate a more transparent calculation of the return on debt than the AER proposal.

In summary, the EURCC proposal largely contains elements that would not meet the NEO.

The Businesses' alternative proposed Rule change

The Businesses set out below proposed solutions, in the form of the preferable Rule changes, to each of the problems the Businesses have identified above.

Problem: The Rules contemplate that the return on debt should be forward looking, whereas NSPs' actual costs of debt are both backward and forward looking at the time of an AER determination. The efficiency objectives of the NEO may not be achieved if an NSP is not provided with a reasonable opportunity to recover at least efficient costs.

Preferable Rule change: The Rules should be amended to prescribe a mixed forward and backward looking approach to establishing the return on debt, which closely aligns to benchmark NSP exposures.

Problem: NSPs typically face different term exposures on the swap rate and debt margin over swap, but the Rules require the term to maturity of the risk free rate to also apply to DRP.

Preferable Rule change: The Rules should be amended to remove the requirement for the term to maturity of the risk free rate to also apply to the DRP.

Problem: The Rules distinguish between risk free rate and DRP, whereas NSPs' cost exposures are to the swap rate and debt margin over swap.

Preferable Rule change: The Rules should be amended to re-define the return on debt in terms of the swap rate and debt margin over swap.

Problem: There is no explicit provision in the Rules for the recovery of other debt costs which are a material cost to an efficient NSP.

The discussion above and the evidentiary material accompanying this Response demonstrate that an efficient NSP also incurs other material debt financing costs including early refinancing, hedging, and debt raising costs. The current Rules are silent on how or where these costs are to be recovered in the building blocks. These costs are not currently considered in a consistent way by the AER. Debt raising costs have been considered under opex whilst hedging costs have effectively been included in the return on debt, as demonstrated from the following extract from the AER's 2009 SORI Decision in the last WACC review:[402]

> Retention of a 10-year term assumption is a conservative position which is expected to result in over-compensation on average. Based on the empirical evidence the AER estimates that the extent of over-compensation on the cost of debt (leaving aside transaction costs) is 18 bp per annum on average. On this basis the AER considers it inappropriate to allow any explicit compensation for any additional transaction costs (e.g. hedging costs) at the time of a reset.

Preferable Rule change: It would be more appropriate for the Rules to be amended to consolidate other debt costs in the definition of return on debt because other debt costs are:

- material in nature;
- generally substitutable with the DRP, which means that if they are not considered holistically in the determination of the cost of debt, there is the potential for inconsistent allowances. Examples of substitutability include:
    - exchange rate hedging would be incurred for foreign denominated debt, but not Australian dollar denominated debt;
    - early refinancing can differ depending on the type of debt issued;

[402] 2009 SORI Decision, p168.

    - a retail offer may incur higher debt raising costs and lower DRP compared to a private placement; and
- reported as financing costs and not opex in the financial statements of an NSP.

The preferable Rules changes identified above can be consolidated into a proposal for change to the Rules which amends the existing Rules governing estimation of the return on debt to:

- define the return on debt as the sum of the swap rate, the debt margin and other debt costs;
- specify that the swap rate for the purposes of this definition is the annualised BBSW rate with a term equal to the length of the regulatory control period and determined in an averaging period proposed by the NSP and agreed by the AER, similar to the current Rule requirement for estimation of the nominal risk free rate;
- specify that the debt margin for the purposes of this definition is the annualised average historic spread to swap of Australian corporate bonds with a maturity structure and credit rating reflective of a benchmark NSP; and
- specify that the other debt costs for the purposes of this definition are the debt raising, early debt refinancing and hedging costs, not already included in the debt margin, of a benchmark efficient NSP.

Further changes would be required to accommodate the annual 'true-up' between the debt margin forecast in the determination and the calculated rolling average benchmark debt margin.

The rolling backward looking benchmark approach for measuring the debt margin would require significant consultation to determine how the mechanism would work, the level of prescription required and the consequential Rule changes.

For clarity, the Businesses observe that the Businesses' proposed Rule change does not require any change to the definition of the nominal risk free rate, which would only apply to the return on equity.

The Businesses consider that the Businesses' proposed Rule change performs well when assessed against the criteria proposed by the Businesses for assessment of Rule changes relating to the definition of the cost of debt, as follows:

1 Incentives for efficient investment

Assuming that efficient investment would only be promoted if NSPs have a reasonable opportunity to recover efficient costs, the Businesses' proposed Rule change satisfies this criterion for the reasons discussed below in relation to criterion 2.

2 Reasonable opportunity to recover at least efficient costs

A mixed forward and backward looking approach to establishing the return on debt, and the definition of the return on debt in terms of swap rate and debt margin, provides a reasonable opportunity for the NSP to recover its efficient costs.

3 Flexibility to accommodate various market conditions and data availability

The removal of the requirement for the term to maturity of the risk free rate to also apply to DRP, would provide sufficient flexibility to accommodate changes in market conditions and data availability.

4 Predictability so that an NSP can efficiently manage risks

The Businesses' proposed Rule change would provide sufficient predictability for an NSP to efficiently manage risks on a forward looking basis.

5 No material increase in level of risk associated with existing debt

The Businesses' proposed Rule change would not increase the level of risk for an NSP.

6 Transparency

The Businesses' proposed Rule change would facilitate a more transparent calculation of the return on debt than the AER Rule Change Proposal.

In summary, therefore, the Businesses' proposed Rule change satisfies the criteria for assessment of Rules changes and thus would, if made, contribute to the achievement of the NEO and RPPs relative to the current Rules.

Summary

The AER Rule Change Proposal does not contribute to the achievement of the NEO and RPPs relative to the existing Rules because the proposed conferral on the AER of an unfettered discretion to determine the return on debt estimation methodology in a WACC review:

- will result in a lack of certainty and so will hamper efficient investment;
- based on the failure by the AER in the AER Rule Change Proposal to recognise the impact on the cost of equity of differing debt maturities, will result in a high risk that the return on debt will not provide a reasonable opportunity to recover efficient costs;
- may not be sufficiently flexible to accommodate various market conditions and data availability;
- will not provide the required level of predictability for DNSPs to effectively manage risks; and
- is unlikely to result in transparent decisions due to lack of accountability, as merits review is not available in respect of decision making in a WACC review.

The EURCC proposal does not contribute to the achievement of the NEO and RPPs relative to the existing Rules because it will:

- not provide a reasonable opportunity to recover efficient costs, as it incorrectly assumes that NSPs issue fixed rate debt, and incorrectly assumes that an efficient NSP will refinance 20% of total debt each year, and does not accommodate other debt costs; and
- result in a material increase in NSPs' risk associated with the risk free rate.

By contrast, the Businesses' proposed Rule change is expected to better meet the NEO and RPPs.

ANNEXURE C - REGULATORY DECISION-MAKING PROCESS

As noted by the AEMC in making the Rules in their current form (at that time, for transmission):[403]

> [W]ell designed procedural requirements assist in ensuring that the regulator administers the regulatory regime in an appropriate manner. This includes providing opportunities for regulated businesses and interested stakeholders to make submissions to the regulator and the opportunity for full and thorough analysis of the submissions and the regulator's decisions (including draft decisions). Transparent decision making in this way is conducive to reducing regulatory risk, and the probability of error and decreasing the administrative costs of regulation.

Overall the Businesses consider that the majority of the AER's proposed Rule changes would reduce the opportunity for full and thorough analysis of submissions and the AER's draft decision and increase the risk of regulatory error. The AER's proposed changes would thus fail to promote the NEO and would be inconsistent with the RPPs. The Businesses consider that, in most instances, the existing Rules strike the correct balance between codification of processes and regulator discretion. Only minor amendments to the current Rules are required to improve the efficiency and effectiveness of the regulatory decision-making process to further promote the NEO and RPPs.

C.1 SUBMISSIONS RECEIVED DURING A DETERMINATION PROCESS

AER Proposed Rule Change

Current Rule provisions

The Rules in their current form establish a clear process for the lodging of regulatory proposals, revised regulatory proposals and written submissions during a distribution determination process. The process includes the following:

- the DNSP must lodge a regulatory proposal at least 13 months before the expiry of the distribution determination that applies to it.[404] The regulatory proposal must include, among other things, a building block proposal for standard control services (used to determine the annual revenue requirement for each year of the regulatory control period);[405]
- the AER must publish the regulatory proposal and invite written submissions on the regulatory proposal.[406] Any person may make a written submission to the AER within the time specified in the invitation, which must not be earlier than 30 business days after the invitation for submissions is published;[407]

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[403] 2006 TNSP Rule Determination, p33.

[404] Clause 6.8.2(b) of the Rules.

[405] Clause 6.8.2(c)(2) of the Rules.

[406] Clause 6.9.3(a) of the Rules.

[407] Clause 6.9.3(c) of the Rules.

- the AER must publish its draft distribution determination and invite written submissions on the draft determination.[408] Any person may make a written submission to the AER on the draft determination within the time specified in the invitation, which must not be earlier than 30 business days after the making of the draft determination;[409]

- the DNSP may lodge a revised regulatory proposal with the AER, not more than 30 business days after the publication of the draft distribution determination.[410] In that revised regulatory proposal, the DNSP may only amend its regulatory proposal and may only do so to address matters raised by the draft determination or the AER's reasons for it;[411] and

- the AER may, but need not, invite written submissions on the revised regulatory proposal.[412] The Rules expressly provide that the DNSP has a right to submit a revised regulatory proposal '[i]n addition to making written submissions'.[413]

A flow chart of the consultation provided for in the Rules is set out in Figure 2 below. The steps with a solid outline are mandatory, while the steps with a dotted outline are optional.

[408] Clause 6.10.2(a) of the Rules.

[409] Clause 6.10.2(c) of the Rules.

[410] Clause 6.10.3(a) of the Rules.

[411] Clause 6.10.3(c) of the Rules.

[412] Clause 6.10.3(e) of the Rules.

[413] Clause 6.10.3(a) of the Rules.

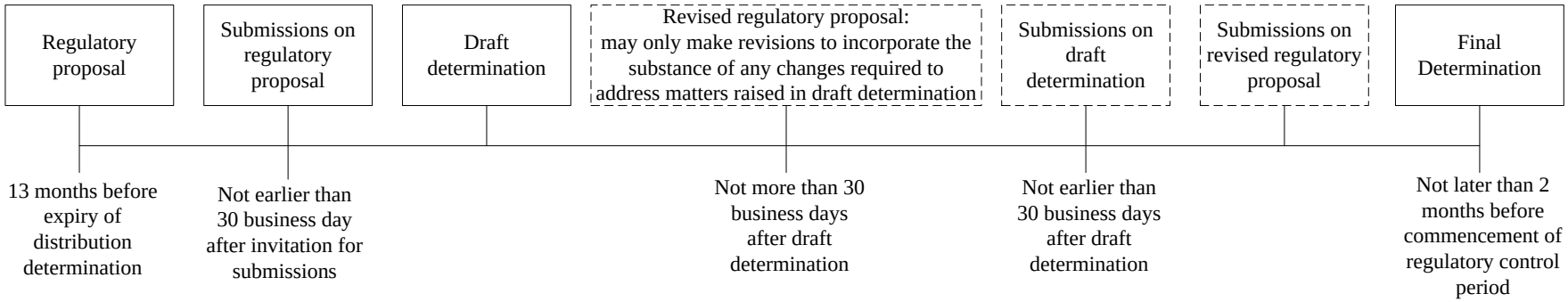

Figure 2 - Consultation provided for in the Rules

AER's characterisation of 'the problem'

The AER expressed concern that NSPs have used the Rule provisions that permit the making of submissions on the AER's draft decision 'to submit information which should have properly formed part of their regulatory or revenue proposals'.[414] The AER considers this:[415]

- denies other stakeholders the opportunity to consider, and make submissions on, the further information submitted by NSPs; and
- leaves the AER with less time to assess the material, take into account submissions and make a final determination, which impedes the AER's ability to properly assess the further information.

AER's proposed Rule changes

Using drafting suggestions provided by AGS, the AER proposed changes to the Rules to:[416]

- provide that a DNSP may only make submissions in response to an invitation for written submissions in respect of a regulatory proposal or revised regulatory proposal if the regulatory proposal or revised regulatory proposal was submitted by another DNSP;
- provide that a DNSP may only make submissions in response to an invitation for written submissions in respect of a draft determination if the draft determination was made in respect of another DNSP;
- limit the matters that can be dealt with by a DNSP in response to such notices:
    - in the case of a submission on another DNSP's regulatory proposal or revised regulatory proposal, to 'material differences' between the proposal that was submitted by it and the proposal that was submitted by the other DNSP; and
    - in the case of a submission on a draft determination in respect of another DNSP, to 'material differences' between the draft determination that has been made in relation to it and the draft determination that has been made in relation to the other DNSP; and
- prohibit the AER from considering submissions or material that do not comply with the proposed clauses described in the above bullet points.

The AER's Rule change proposal, in so far as it relates to the ability of a DNSP to make submissions in its own regulatory process, is set out in Figure 3 below. The changes to the consultation provided for in the current Rules are shown in single underlined blue text.

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[414] AER Rule Change Proposal, p85.

[415] AER Rule Change Proposal, p87.

[416] AER Draft Rules, pp44-7, 53 (proposed clauses 6.9.3, 6.10.2, 6.10.3, 6.14.1).

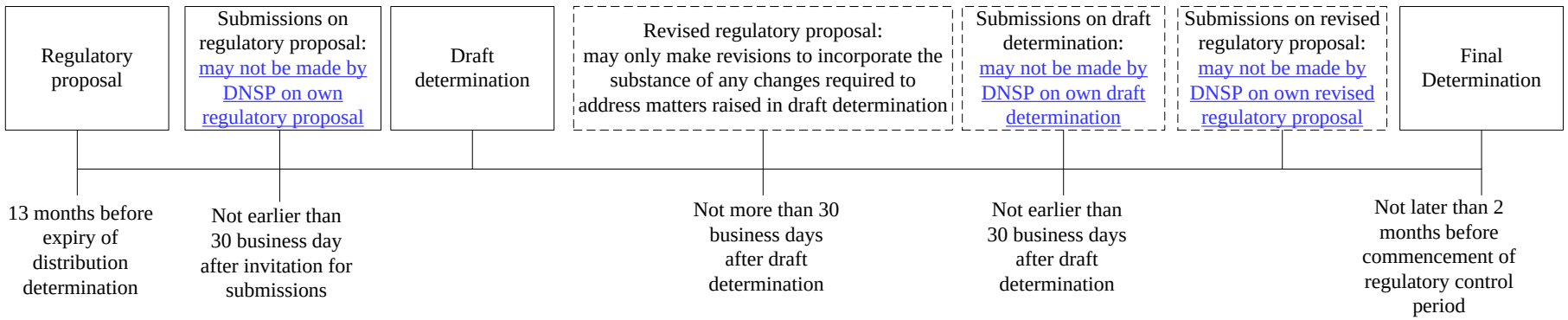

Figure 3 - Changes to consultation provided for in the Rules proposed by the AER

Businesses' Response

Introduction

While the AER has not raised objections to the Businesses' submissions on initial regulatory proposals in the past,[417] the Businesses appreciate that the requirement to consult on the initial regulatory proposal is largely intended to provide for third party stakeholder comment on the relevant DNSP's regulatory proposal. The Businesses therefore do not object to the AER's proposed amendment to clause 6.9.3 of the Rules to prevent DNSPs from making submissions on their own (initial) regulatory proposals.

The Businesses reject, however, the AER's suggestion that they have undermined the policy objectives underpinning the Rules by making submissions to the AER after lodging their revised regulatory proposals and by lodging material that 'should' have formed part of the revised regulatory proposal.[418]

First, the Businesses observe that the Rules expressly provide for the making of such submissions. They do so because, in submitting revised regulatory proposals under the Rules, DNSPs are only permitted to amend their regulatory proposals so as to address matters raised by the draft determination or the AER's reasons for it. Accordingly, the Rules contemplate that revised regulatory proposals can be supplemented by the making of submissions to the AER. Clause 6.10.3(a) of the Rules, for instance, states: '**In addition to making written submissions**, the [DNSP] may ... submit a revised *regulatory proposal* to the *AER*' (emphasis added in bold).

Further, whereas the AER considered only the possibility of NSPs making submissions on issues that are common across proposals,[419] the Businesses note that there are a range of circumstances that might compel an NSP to make submissions after lodging its revised regulatory proposal, which submissions could not have formed part of the proposal.

The Businesses also observe that the existing Rules do not provide stakeholders with a right to make submissions on either the revised regulatory proposal or any other stakeholders' submissions on the draft determination or revised regulatory proposal. The only right to make submissions that is expressly provided for by the Rules after the AER's draft determination is the right to make submissions on that draft determination.

The Businesses agree with the AER that a robust consultation process is desirable as it reduces the potential for regulatory error, and that in order to achieve this, a change to the Rules is required. However, the Businesses have significant concerns with the AER's proposals to address its perceived 'problem', in particular, the AER's proposals to:

- curtail a DNSP's ability to make submissions on the AER's draft determination under clause 6.10.2 while maintaining the limitation on the material that can be included in a DNSP's revised regulatory proposal under clause 6.10.3; and

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[417] For example, the AER advised ETSA Utilities that it would be able to take into account in its draft determination any materials provided to it by the closing date for submissions on its regulatory proposal: Letter from Mr Eric Lindner, General Manager Regulation, ETSA Utilities to Mr Adam Peterson, Director - Network Regulation South, AER dated 28 August 2009, p1.

[418] AER Rule Change Proposal, p85.

[419] AER Rule Change Proposal, p87.

- include prohibitions in clause 6.14.1 on the AER considering submissions that do not comply with the Rules.

The Businesses submit that these proposed changes are inconsistent with the AER's other proposed Rules changes and section 16 of the Law, do not promote the NEO and are contrary to the RPPs. These issues are outlined further below, after a brief comment as to the extent of 'the problem' perceived by the AER.

Extent of 'the problem' perceived by the AER

The Businesses observe that while AGS proposed the drafting amendments put forward by the AER, AGS did so on the presumption that the 'problem' as described by the AER existed.[420] That is, AGS did not independently consider the extent of the problem as described to it by the AER.

The Businesses consider that the AER has mischaracterised as a 'problem' the making of submissions on the AER's draft determination by NSPs. In circumstances where the matters that a DNSP can address in its revised regulatory proposal are limited, DNSPs have relied on the express right to make submissions under the Rules to make submissions on a range of issues arising under the AER's draft determination.

The Businesses also consider that the AER has sought to characterise as a 'problem' NSPs lodging material with the AER for a range of legitimate reasons that meant they were not able to produce the material with their revised regulatory proposals.

For instance, CitiPower and Powercor Australia submitted material to the AER after their revised regulatory proposals had been lodged for two key reasons.

First, CitiPower and Powercor Australia made submissions relating to material that was not available at the time their revised regulatory proposals were lodged. For example, CitiPower and Powercor Australia made submissions to the AER regarding the recommendations of the VBRC.[421] The VBRC's recommendations were handed down after CitiPower's and Powercor Australia's revised regulatory proposals were submitted to the AER. It was therefore not possible for CitiPower and Powercor Australia to make these submissions in their revised regulatory proposals, and the material was not material that 'should have properly formed part of [their revised regulatory proposals]'.

Secondly, as DNSPs are allowed only 30 business days after the AER publishes its draft determination to submit revised regulatory proposals,[422] and the AER typically allows a longer period for the making of written submissions, CitiPower and Powercor Australia made submissions to the AER to supplement and clarify their revised regulatory proposals. Draft determinations published by the AER are necessarily voluminous. For example, the public version of the AER's reasons for decision published in support of its draft determinations in respect of the Victorian DNSPs was 998 pages, and was accompanied by 350 pages of appendices, seven expert reports and around 20 Excel spreadsheets per DNSP (constituting the models and data sources on which the

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[420] Letter of advice from Dr Michael O'Rourke, Counsel, AGS to Mr Anthony Goh, Senior Lawyer, ACCC, 'Advice on possible amendments to the National Electricity Rules', 27 September 2011, [17].

[421] Letter from Mr Richard Gross, General Manager Regulation and BDI, CitiPower and Powercor Australia to Mr Chris Pattas, General Manager, Network Regulation South Branch, AER, 'Victorian Bushfire Royal Commission - implications of Final Report for the EDPR', 19 August 2010.

[422] See clause 6.10.3(a) of the Rules.

AER's draft determination for each DNSP was made). Similarly, the public version of the AER's decision in respect of ETSA Utilities was 465 pages, and was accompanied by 145 pages of appendices, seven expert reports and three Excel spreadsheets.

Given the length of the AER's draft decisions, and the complexity of the material contained in (and accompanying) them, 30 business days is not a sufficiently long period of time within which to prepare a response to adequately mitigate the risk of regulatory error. This is particularly the case where external expertise is required to address issues raised by the AER. As the AER has typically allowed longer than 30 business days for the making of written submissions on its draft determination,[423] the submissions process has provided NSPs with an opportunity to produce additional material in support of their revised regulatory proposals where it has not been possible to prepare this material in advance of the proposals being submitted to the AER.

The example cited in Box 8.1 of the AER Rule Change Proposal of CitiPower and Powercor Australia providing additional materials in relation to the calculation of early refinancing costs is an example of this.[424] CitiPower and Powercor Australia required supporting material from third parties to make technical submissions regarding early refinancing costs. CitiPower and Powercor Australia did not receive this material time in sufficient time to produce it to the AER with their revised regulatory proposals. In accordance with the Rule provisions permitting submissions in addition to the revised regulatory proposal, therefore, CitiPower and Powercor Australia produced a further submission which set out their response to the AER's draft determination, which explained how CitiPower and Powercor Australia calculated the allowances for debt raising costs set out in their revised regulatory proposals[425] and was accompanied by a witness statement drawing on information provided by a range of third parties.[426] While the forecasts of debt raising costs included in the revised regulatory proposals were not updated in the submission (other than to correct for typographical errors),[427] the material was, nonetheless, a significant element of CitiPower's and Powercor Australia's response to the AER's draft determination and was submitted in the interests of reducing the risk of regulatory error. In any event, the Businesses observe that, while the AER raised concerns that interested parties were denied a proper opportunity to make submissions on this part of their revised regulatory proposals, the AER did not accept the early refinancing costs proposed by CitiPower and Powercor Australia and adopted the benchmark amounts determined by its own consultant.[428]

Finally, while the AER submits that once all of the prescribed consultation requirements are adhered to it is left with 'less (or arguably insufficient) time' to assess any revised regulatory proposal, take

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[423] In the case of each of the Businesses, the AER allowed almost another month after they were required to submit their revised regulatory proposals for the making of written submissions.

[424] AER Rule Change Proposal, p86.

[425] CitiPower and Powercor Australia, Submission on the AER's draft distribution determination 2011-2015, Appendix P: Debt raising costs, 19 August 2010, p2.

[426] Statement of Julie Marie Williams dated 19 August 2010 (public version), [9], [51], [58]-[59], [110].

[427] CitiPower and Powercor Australia, Submission on the AER's draft distribution determination 2011-2015, Appendix P: Debt raising costs, 19 August 2010, p3.

[428] Victorian Distribution Determinations Draft Decision, pp369-70, Appendix N.

into account submissions and make a final determination,[429] the Businesses observe that the amount of time the AER has between its draft and final determinations is largely determined by it. The amount of time available to the AER to consider material submitted to it after its draft determination is a product of the AER's decision as to when, in the 11 months following the submission of the initial proposal,[430] to publish its draft determination. The longer the AER takes to publish its draft determination (the timing of which is not prescribed by the Rules), the smaller the proportion of the 11 months available to the AER it has to consider revisions made by the DNSP to its regulatory proposal and submissions on its draft determination and make its final determination. The AER's timeline for the Victorian distribution review and its distribution review in South Australia are shown in the table below.

Activity	Timeline in Victorian distribution review	Timeline in South Australian distribution review
Regulatory proposals submitted	30 November 2009	1 July 2009
Submissions on regulatory proposal closed	24 February 2010	28 August 2009
Draft determination	4 June 2010	30 November 2009
Revised regulatory proposals submitted	21 July 2010	14 January 2010[431]
Submissions on draft determination and revised regulatory proposals closed	19 August 2010	16 February 2010
Final determination	29 October 2010	6 May 2010[432]

Table 8 - Consultation timelines in Victorian and South Australian distribution reviews

The table shows that in Victoria, the AER took longer than six months to publish its draft determination, over half of the 11 months available to it for the entire distribution review. In South Australia, the AER took five months to publish its draft determination, again almost half of the time available to it to conduct the review. The AER could have increased the time available following

[429] AER Rule Change Proposal, p87.

[430] Clause 6.8.2(b)(1) of the Rules requires a DNSP to submit its regulatory proposal at least 13 months before the expiry of a distribution determination and clause 6.11.2 provides that the distribution determination must be published no later than 2 months before the commencement of the relevant regulatory period. The difference between these two dates is 11 months.

[431] ETSA Utilities had a shortened effective period within which to submit its revised regulatory proposal due to the period coinciding with the Christmas and New Year period. ETSA Utilities found it extremely difficult to access resources, particularly external resources, during that period.

[432] The Businesses observe that on 30 March 2010, the AER advised that an extension to the timeframe for the making of final determination in respect of ETSA Utilities was required to incorporate modelling into the March quarter consumer price index to be released by the Australian Bureau of Statistics on 28 April 2010: AER, Market notice, 30 March 2010 (screenshot).

the close of submissions on the draft determination and revised regulatory proposals by making its draft determinations earlier than it did.

AER's proposed restrictions on DNSP submissions are inconsistent with its other proposed Rule changes

Not only do the Businesses reject the extent of the 'problem' identified by the AER, the Businesses have significant concerns with the AER's proposed revisions to address the perceived problem.

The AER's proposed restrictions on a DNSP's ability to make submissions on the AER's draft determination in respect of it are wholly inconsistent with its proposed changes to the regulatory framework. Specifically, the AER has proposed Rule changes to replace the 'propose-respond' model for opex and capex with a 'receive-determine' model under which the AER receives the regulatory proposal but then itself determines the opex and capex forecasts that it considers would meet the efficient costs that a prudent NSP would require to achieve the opex and capex objectives.

This is a fundamental shift in the decision-making framework. Under such a framework the AER is not tied to making a determination by reference to the NSP's regulatory proposal and thus:

- the 'starting point' for the AER's final determination is the AER's draft determination (rather than a DNSP's proposal). The expenditure forecasts in respect of which the AER should be consulting are those in its draft determination (rather than the DNSP's proposal); and

- the AER's rationale for requiring NSPs to submit revised opex and capex forecasts prior to consultation with stakeholders closing falls away. If anything, the NSP (being the party most directly affected by the AER's decision) should be provided with an opportunity to comment on other stakeholder submissions after the time for making these submissions has closed.

AER's proposed restrictions on DNSP submissions are inconsistent with section 16 of the Law

Further, and more significantly, when considered as a whole, the AER's proposed Rule changes significantly curtail the ability of DNSPs to make submissions in respect of the AER's determinations in respect of them and thus directly conflict with section 16 of the Law.

Section 16(1)(b) of the Law provides that the AER must, in performing or exercising a function or power that relates to the making of a distribution determination, ensure that the regulated DNSP to whom the determination will apply is given a reasonable opportunity to make submissions in respect of that determination before it is made. The provision embodies, in effect, the common law principle of procedural fairness.

If the Rule changes proposed by the AER to prevent the making of submissions on the AER's draft determination were made, in circumstances where the restrictions in the existing Rules on what can be included in a DNSP's revised regulatory proposal are maintained, DNSPs would be prevented from:

- responding to interested party submissions on their initial regulatory proposals. Whereas the AER asserts that 'the proposed rules would not restrict NSPs' ability to make submissions on ... submissions from other stakeholders into the transmission or

distribution process',[433] as a practical matter the AER's draft Rules would not provide for the making of submissions by the NSP on interested party submissions. By removing the opportunity to make submissions following the draft determination, and maintaining the restriction on what can be included in the revised regulatory proposal, no opportunity would exist under the decision-making process to make submissions on stakeholder submissions on an initial regulatory proposal;

- responding to the draft determination except so as to incorporate the substance of any changes to the initial regulatory proposal required to address matters raised by the draft determination;

- adducing additional material in support of their initial regulatory proposals, including where this material becomes available only after the lodgement of the initial regulatory proposal; and

- adducing additional material regarding any change in circumstances or other development occurring after the lodgement of the initial regulatory proposal.

The result is that the DNSPs would be denied the opportunity to make submissions in respect of key parts of the determination relating to them before that determination is made, contrary to section 16 of the Law.

As Rules enacted by the AEMC are delegated legislation made and amended under the Law,[434] the above inconsistency with the Law, as well as the inconsistency with the principles of procedural fairness, would likely have the effect of invalidating any such Rules.[435]

While in its letter of advice AGS explicitly refers to section 16(1)(b) of the Law,[436] it does not address whether and how the proposed amendments are consistent with that provision or whether it would be enforceable. Nor does the AER address this issue in its Rule Change Proposal.[437]

Proposed restrictions on DNSP submissions are inconsistent with the NEO and the RPPs

As well as being inconsistent with the AER's other proposed Rule changes and section 16 of the Law, the AER's proposed Rule changes are inconsistent with the NEO and the RPPs.

In the first instance, the Businesses observe that it should be assumed that the provisions of the Law were enacted and have been retained because the legislature considers they promote the NEO and the RPPs. The Businesses therefore submit that any inconsistency with the Law demonstrates an inconsistency with the NEO and the RPPs. Further, however, the inconsistency of the AER's proposed Rule changes with the NEO and the RPPs can be seen as follows.

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[433] AER Rule Change Proposal, p89.

[434] Rule 1.2 of the Rules; sections 88, 90, 90A, 90B and 90C of the Law.

[435] See Dennis Pearce and Stephen Argument, *Delegated Legislation in Australia* (3rd edition, 2005) at [19.9], [19.31].

[436] Letter of advice from Dr Michael O'Rourke, Counsel, AGS to Mr Anthony Goh, Senior Lawyer, ACCC, 'Advice on possible amendments to the National Electricity Rules', 27 September 2011, [13].

[437] See AER Rule Change Proposal, pp85-9.

By preventing NSPs from making submissions to the AER and maintaining the limitations on what NSPs can include in their revised regulatory proposals, the AER's proposed Rule changes would impede the AER's ability to conduct a 'full and thorough' assessment, thereby increasing the risk of regulatory error. As noted above, the changes would prevent NSPs from providing a range of relevant information to the AER prior to the making of the final determination, including information in response to interested party submissions and information regarding changes in circumstances that arise after the initial regulatory proposals have been submitted. Given a DNSP must submit its initial regulatory proposal 13 months before the next regulatory control period,[438] and the AER must publish its final determination two months before the next regulatory control period,[439] there is a considerable period over which the AER would be prevented from having regard to new matters raised that would otherwise have been raised in DNSP submissions.

Such a proposal, if adopted, would not promote efficient investment in, and efficient operation and use of electricity services and cannot be said to contribute to the NEO. It would also inhibit the AER's ability to ensure NSPs are provided with a reasonable opportunity to recover efficient costs, contrary to the RPPs.

Alternative solution to the 'problem' with the current Rules

The Businesses observe that AGS drafted the amendments to the Rules to give effect to changes that the AER considered were necessary in light of the problems perceived by the AER.[440] That is, AGS did not independently consider whether the changes advanced by the AER were necessary to address the problem perceived by the AER or whether or how the changes were consistent with the Law, the NEO or the RPPs.

The Businesses propose alternative amendments to Chapter 6 of the Rules that seek to provide for robust stakeholder consultation but which are not inconsistent with section 16 of the Law, the NEO or the RPPs. These proposed amendments are set out below.

By way of summary, the Businesses proposed amendments to the AER's Rule change proposal are designed to allow DNSPs to include with their revised regulatory proposals submissions to the AER:

- in response to stakeholder submissions on the initial regulatory proposal. This will be the first opportunity the DNSP has to make submissions on stakeholder submissions;
- in support of the initial regulatory proposal (including where that proposal is not revised);
- in response to any aspect of the AER's draft determination (whether or not the subject of a revision in the revised regulatory proposal); and
- regarding any changed circumstances or other developments that are not reflected in the initial regulatory proposal,

(proposed clause 6.10.3(b1)).

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[438] Clause 6.8.2(b) of the Rules.

[439] Clause 6.11.2 of the Rules.

[440] Letter of advice from Dr Michael O'Rourke, Counsel, AGS to Mr Anthony Goh, Senior Lawyer, ACCC, 'Advice on possible amendments to the National Electricity Rules', 27 September 2011, [23].

Further, given that 30 business days is an insufficient period of time for DNSPs to prepare all material in response to the AER's draft determination, the Businesses propose an amendment to extend the period of time available to DNSPs to prepare their revised regulatory proposals from 30 business days to 40 business days (clause 6.10.3(a)).

In addition, whereas the AER has sought to address the issue of ensuring stakeholders have adequate opportunity to comment by limiting the ability of NSPs to make submissions, the Businesses consider that the AER's perceived problem can be addressed through the introduction of new provisions to establish a 'cross-submission' process following the closing of interested party submissions on the draft determination and revised regulatory proposal, in which all stakeholders (including the DNSP the subject of the AER's determination) are permitted to make submissions on issues raised in any other submissions made to the AER. The Businesses propose a period of 10 business days for the making of these submissions (proposed clause 6.10.4).

Finally, the Businesses propose consequential amendments to clause 6.14(c) of the Rules in their current form.

The Businesses' suggested amendments to the AER's Rule change proposal, in so far as it relates to the ability of a DNSP to make submissions in its own regulatory process, is set out in Figure 4 below. The changes to the consultation provided for in the current Rules as proposed by the AER are shown in single underlined text. The further changes suggested by the Businesses are shown in double underlined red text.

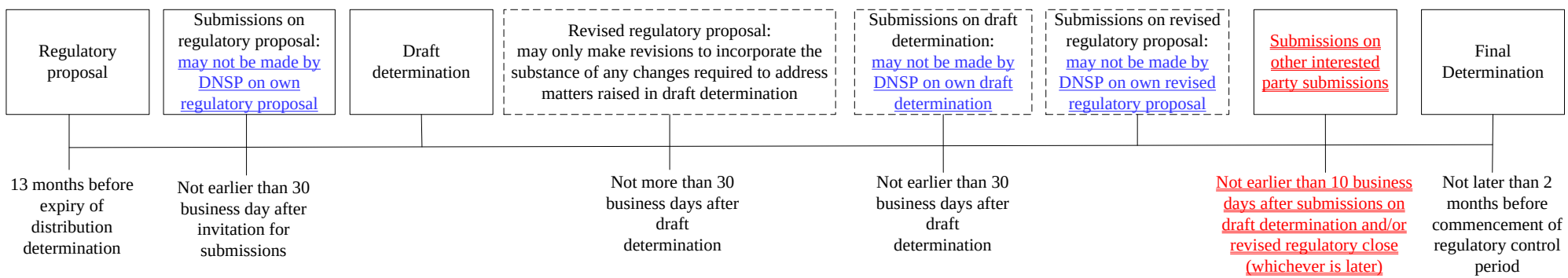

Figure 4 - Changes to the consultation process proposed by the AER suggested by the Businesses

Summary

The AER's proposed Rule changes to reduce the ability of NSPs to make submissions on their own proposals and draft determinations, in circumstances where the limitations on what can be addressed in revised regulatory proposals are maintained, are not likely to contribute to the achievement of the NEO and would be inconsistent with the RPPs. In particular, NSPs would be deprived of the opportunity to inform the AER of issues relevant to the AER's determination, which would mean that the AER is less likely to be in a position to make a full and thorough assessment and thus be less likely to be in a position to:

- make a determination that promotes the efficient investment in, and efficient operation and use of, electricity services; and
- ensure that the NSP is provided with a reasonable opportunity to recover its efficient costs.

The risk of regulatory error would therefore be increased under the AER's proposed Rule changes.

The Businesses submit that, to the extent the AEMC determines that a change to the Rules to facilitate greater consultation than is presently provided for is desirable, the Rules proposed by the AER should be amended as set out below.

6.10.3 Submission of revised proposal

(a) ~~In addition to making written submissions, t~~The *Distribution Network Service Provider* may, not more than ~~30~~40 *business days* after the publication of the draft distribution determination, submit a revised *regulatory proposal* to the *AER*.

(b) A *Distribution Network Service Provider* may only make the revisions referred to in paragraph (a) so as to incorporate the substance of any changes required to address matters raised by the draft distribution determination or the *AER's* reasons for it.

(b1) In submitting its revised *regulatory proposal* to the *AER*, a *Distribution Network Service Provider* may make submissions:

(1) in response to any submissions to the *AER* on the *Distribution Network Service Provider's regulatory proposal*;

(2) in further support of its *regulatory proposal*, regardless of whether the matter was raised by the draft determination or the *AER's* reasons for it;

(3) in response to any aspect of the draft determination or the *AER's* reasons for it; and

(4) to address any changed circumstances or other developments that are not reflected in its *regulatory proposal*.

(c) A revised *regulatory proposal* must comply with the requirements of, and must contain or be accompanied by the information required by, any relevant *regulatory information instrument*.

(c1) A revised *regulatory proposal* must identify the parts of the proposal (if any) the *Distribution Network Service Provider* claims to be confidential.

(d) Subject to the provisions of the Law and the *Rules* about the disclosure of *confidential information*, the *AER* must *publish* a revised *regulatory proposal* submitted by the *Distribution Network Service Provider* under paragraph (a), together with the accompanying information, as soon as practicable after receipt by the *AER*.

(e) The *AER* may, but need not, ~~invite~~ publish a notice inviting, from any person other than the *Distribution Network Service Provider* that submitted the revised *regulatory proposal*, written submissions on the revised *regulatory proposal*.

(f) Paragraphs (g), (h) and (i) apply if the *AER publishes* a written notice under paragraph (e).

(g) Any person, other than the *Distribution Network Service Provider* that submitted the proposal, may make a written submission to the *AER* on the revised *regulatory proposal* within the time specified in the notice, which must be not earlier than 30 *business days* after the publication of the notice.

(h) A *Distribution Network Service Provider* may only make a written submission in response to a notice *published* under paragraph (e) in respect of a revised *regulatory proposal* that was submitted by another *Distribution Network Service Provider*.

(i) Where:

(1) the *AER* is making distribution determinations in relation to two or more *Distribution Network Service Providers* at the same time; and

(2) a *Distribution Network Service Provider* makes a written submission referred to in paragraph (h),

that written submission may only address material differences between:

(3) the revised *regulatory proposal* that was submitted by it; and

(4) a revised *regulatory proposal* that was submitted by another *Distribution Network Service Provider*.

6.10.4 Consultation on further submissions

(a) The *AER* must *publish* an invitation for written submissions on any written submissions on the draft determination or revised *regulatory proposal*.

(b) Any person may make a written submission to the *AER* within the time specified in the invitation referred to in paragraph (a), which must not be earlier than 10 *business days* after the later of:

(i) the *publication* of the invitation for submissions under paragraph (a);

(ii) the time specified in the invitation for written submissions *published* under clause 6.10.2; and

(iii) if there was such an invitation, the time specified in the invitation for written submissions *published* under clause 6.10.3.

…

6.14 Miscellaneous

…

(c)~~(b)~~ Subject to paragraph (d)~~(c)~~, as soon as practicable after the *AER* receives a submission in response to an invitation referred to in clause 6.9.3(a)(2), ~~or~~ 6.10.2(a)(5), 6.10.3(e) or 6.10.4(a) (whether or not the submission was made before the time for making it has expired), the *AER* must *publish* that submission.

C.2 LATE SUBMISSIONS AND REGULATORY PROPOSALS

AER Proposed Rule Change

Current Rule provisions

Under the existing Rules, the AER has an express discretion to consider any submission made to the AER pursuant to an invitation for written submissions after the time for making the submission has expired.[441]

AER's characterisation of 'the problem'

The AER suggested that the making of late submissions and the late lodgement of regulatory proposals impedes the AER's ability to assess the information included in these.[442]

AER's proposed Rule changes

The AER proposed to remove the AER's discretion to consider any late submission made to the AER and to prohibit the AER from considering late submissions and late revised regulatory proposals.[443]

Businesses' Response

Introduction

The Businesses support the discretion that the AER has under the existing legislative framework to take late submissions into account. The AER has not advanced any justification for removing the AER's discretion to have regard to late submissions or prohibiting the AER from taking late submissions and regulatory proposals into account.

The AER's proposed changes are not required to control the flow of information to the AER and are inconsistent with sections 16 and 28ZC of the Law, and inconsistent with the NEO and the RPPs.

AER's proposed changes are not required

The AER does not advance any justification in its Rule Change Proposal for removing its discretion to take late submissions into account.[444]

The Businesses submit that the proposed changes regarding late submissions are not required because under the existing legislative framework[445] the AER has the power not to take into account material that is not provided to it in a timely fashion (even by the NSP the subject of the determination) where it is reasonable to do so.

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[441] Clause 6.14(a) of the Rules.

[442] AER Rule Change Proposal, p87.

[443] AER Draft Rules, p53 (proposed clause 6.14.1).

[444] AER Rule Change Proposal, pp84-9.

[445] Section 28ZC of the Law.

As the Tribunal observed in *Application by EnergyAustralia* [2009] ACompT 8:[446]

> The NEL and the Rules mandate a sequence of, and timetable for, a DNSP's regulatory proposal, the AER's draft decision, the DNSP's revised regulatory proposal and the AER's final determination. To avoid gaming of the sequence, the NEL and the Rules are quite detailed about what is to occur in each sequence, when it is to occur and about the rights and obligations of a DNSP and the AER. It is apparent from the foregoing paragraphs that EA was given a reasonable opportunity to make submissions and did in fact make submissions. A line must be drawn by the AER in its engagement with a DNSP, else it fails to meet the deadlines imposed on it. Certainly, nothing in the NEL or the Rules obliged the AER in this matter to, in effect, give EA a 'second bite of the cherry'.

The Businesses also submit that the proposal to prohibit the AER from taking into account late regulatory proposals or revised regulatory proposals is not required. The Rules impose strict timeframes for the making of regulatory proposals and revised regulatory proposals.[447]

AER's proposed prohibitions are inconsistent with sections 16 and 28ZC of the Law

Further, the AER's proposed amendments to remove clause 6.14(a) of the Rules (which gives the AER a discretion to consider any submission made after the published deadline) and to insert a new clause 6.14.1 to prohibit the AER from considering any late submissions or regulatory proposals may operate in a manner that is inconsistent with section 16(1)(b) of the Law. As it is evident there may be circumstances in which an NSP is compelled to make submissions later than the closing date for submissions (for example, because of key developments occurring after that date), a prohibition on the AER taking those submissions into account would be contrary to the requirement in section 16(1)(b) to ensure that the regulated NSP is given a reasonable opportunity to make submissions in respect of the determination to apply to it before it is made.

In addition, the proposed amendments prohibiting the AER from taking into account late submissions would be inconsistent with section 28ZC of the Law. Section 28ZC of the Law provides that if the AER publishes a notice inviting submissions in relation to the making of an economic regulatory decision, the AER 'must consider every submission it receives within the period specified in the notice' and 'may, but need not, consider a submission it receives after the period specified in the notice expires.' By removing the AER's discretion to take into account late submissions, the AER's proposed Rule change is inconsistent with section 28ZC of the Law, and if enacted would likely be void by reason of this inconsistency.

While in its letter of advice AGS refers to the AER 'acknowledging' sections 16 and 28ZC,[448] AGS does not address the inconsistencies outlined in drafting amendments to the Rules. Nor does the AER address this inconsistency in its Rule Change Proposal.[449]

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[446] *Application by EnergyAustralia and Others* [2009] ACompT 8, [257]. The Tribunal determined in that decision that the AER did not err in failing to give EnergyAustralia an opportunity to make submissions on an expert report relied on by the AER that was not disclosed to EnergyAustralia prior to the making of the final determination. The Tribunal reached its view because, in that instance, the AER's expert report did not 'stray beyond providing appropriate responses to issues raised in the SKM and Huegin reports relied on by EA in preparing its revised regulatory proposal': *Application by EnergyAustralia and Others* [2009] ACompT 8, [257].

[447] Clauses 6.8.2(b) and 6.10.3(a) of the Rules.

[448] Letter of advice from Dr Michael O'Rourke, Counsel, AGS to Mr Anthony Goh, Senior Lawyer, ACCC, 'Advice on possible amendments to the National Electricity Rules', 27 September 2011, [8].

[449] See AER Rule Change Proposal, pp85-9.

AER's proposed prohibitions are inconsistent with the NEO and the RPPs

As noted above, the Businesses observe that it should be assumed that the provisions of the Law have been enacted because the legislature considered they promote the NEO and the RPPs. Any inconsistency with the Law therefore demonstrates an inconsistency with the NEO and the RPPs.

In any event, it can be seen that the AER's proposed Rule change is inconsistent with the NEO and the RPPs because prohibiting the AER from taking into account late submissions and regulatory proposals may require the AER to disregard material that is highly relevant to its determination. This may in turn mean that the AER is not in a position to allow the NSP to recover its efficient costs.

Summary

Given the AER's existing powers to disregard material that is submitted to it late in the decision-making process where it is reasonable to do so, the AER's proposed Rule changes are not required.

Further, the AER's proposal to prohibit the AER from taking into account late submissions and regulatory proposals is not likely to contribute to the achievement of the NEO. As well as being contrary to sections 16 and 28ZC of the Law, the proposed amendment would increase the risk of the AER falling into regulatory error.

C.3 USE OF CONFIDENTIAL INFORMATION

AER Proposed Rule Changes

Current Rule provisions

Under the existing Rules, the AER may give such weight to confidential information in 'submissions' received in response to an invitation for written submissions as it considers appropriate, having regard to the fact that such information has not been made publicly available.[450]

AER's characterisation of 'the problem'

The AER highlighted that whereas it has discretion under the Rules to give reduced weight to confidential information in submissions as it considers appropriate, the same discretion does not exist in respect of confidential information submitted by an NSP in regulatory proposals and revised regulatory proposals.[451]

The AER submitted that changes to the Rules are required to give it discretion to exercise judgment in determining the weight to be given to confidential information included in regulatory proposals in order to improve 'the balance to be struck between confidentiality and transparency'.[452]

AER's proposed Rule changes

The AER proposed changes to the Rules to introduce a new clause to explicitly provide that the AER may give such weight to confidential information identified in a regulatory proposal or revised

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[450] Clause 6.14(e) of the Rules.

[451] AER Rule Change Proposal, p90.

[452] AER Rule Change Proposal, pp90-1.

regulatory proposal as it considers appropriate, having regard to the fact that such information has not been made publicly available.[453]

Businesses' Response

Introduction

At the outset, the Businesses observe that they claimed confidentiality over only a small amount of information in their recent respective distribution determination process. As can be seen from the material published on the AER's website (for CitiPower and Powercor Australia, http://www.aer.gov.au/content/index.phtml/itemId/732017, and for ETSA Utilities, http://www.aer.gov.au/content/index.phtml/itemId/729052) an overwhelming majority of the material in support of their proposals was made publicly available.

In any event, the Businesses consider that the existing regime strikes the correct balance between preserving the confidentiality of sensitive information and ensuring transparency in decision-making. In particular, the Businesses consider that:

- the existing regime correctly draws a distinction between confidential information provided by the NSP the subject of the regulatory determination and confidential information provided by other stakeholders;
- the AER's information gathering powers are such that it can have confidence in confidential information produced by NSPs, even where this information has not been made publicly available; and
- under the existing legislative framework, the AER has a range of powers it can rely on to disclose confidential information submitted by NSPs in order to test its veracity and allow for transparency of decision making.

Distinction should be drawn between confidential information provided by the NSP and confidential information provided by other stakeholders

The Businesses consider that the existing regime correctly draws a distinction between confidential information provided by the NSP the subject of the regulatory determination and confidential information provided by other stakeholders.

Whereas the Rules explicitly give the AER discretion to give less weight to confidential submissions from stakeholders on the basis they are not open to public scrutiny, no corresponding provision exists in respect of regulatory proposals and revised regulatory proposals.[454] The AEMC introduced this provision (at the time, in the context of TNSPs) to address the AER's concern regarding procedural fairness if TNSPs were not permitted to see confidential submissions put forward by stakeholders.[455] In making the Rule, the AEMC stated:[456]

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[453] AER Draft Rules, p54 (proposed clause 6.14.1(e)).

[454] See clauses 6.14(e) and 6A.16(e) of the Rules.

[455] 2006 TNSP Rule Determination, p121.

[456] 2006 TNSP Rule Determination, p121.

> It is essential that there is a degree of transparency surrounding the contents of all submissions considered by the AER in the course of making its decision, and the opportunity for comments contained in submissions, **in particular those critical of a TNSP**, are able to be responded to.
>
> [Emphasis added in bold.]

The distinction between confidential information of NSPs and confidential information of other stakeholders is not surprising given:

- the NSP the subject of an AER determination will necessarily be required to provide more, and significantly more detailed, information than any other participant in the process; and
- the information provided by that NSP is so critical to the making of the determination that it would be inappropriate and likely to involve greater regulatory error to accord less weight to it in the making of a determination.

The importance of ensuring procedural fairness (over maintaining the confidentiality of the information submitted) is also present in the existing provisions of the Law. Under the Law, the AER is authorised to disclose confidential information for the purposes of according natural justice to a person affected by a decision of the AER under the Law or the Rules.[457] The AER can and should rely on this power, for example, when applying the unit rates of one DNSP to the quantities of another for the purposes of assessing the second DNSP's proposed expenditure amounts and/or determining substitute amounts.

The Businesses consider that the distinction between confidential information provided by NSPs and confidential information provided by other stakeholders should continue to be drawn.

AER has extensive information gathering powers

The Businesses note that the AER's information gathering powers are extensive and when utilised result in information that the AER can rely on, even where that information cannot be made publicly available. The AER has power under the Law to require regulated NSPs to provide information to it pursuant to a regulatory information notice.[458] An NSP who is served with a regulatory information notice:

- is required to comply with that notice;[459]
- can be (and in practice is) required to verify the information provided by way of statutory declaration;[460] and
- is subject to penalties for providing to the AER information that the they know is false or misleading.[461]

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[457] Section 28Y(c) of the Law.

[458] Section 28F of the Law.

[459] Section 28N of the Law.

[460] Section 28M of the Law.

[461] Section 28R of the Law.

The AER can therefore have confidence in the veracity of this information regardless of whether interested party consultation is limited for reasons of confidentiality.

AER has a range of powers to disclose confidential information

In any event, under the existing legislative framework, the AER has a range of powers it can rely on to disclose confidential information submitted by NSPs in order to test its veracity and allow for transparency of decision making.

First, the Law expressly provides for the AER to disclose confidential information if:[462]

- the disclosure of the information would not cause detriment to the person who has given it or to the person from whom that person received it; or
- any such detriment would be outweighed by the public benefit in disclosing the information.

The Law thus establishes the threshold as to when transparency of decision-making should take precedence over preserving the confidentiality of information produced to the AER. If the AER accepts that there are valid commercial reasons for information to be kept confidential, and the benefit to the public arising from disclosure would not outweigh the detriment to the NSP or its third party service providers (such that the AER could not disclose in accordance with its existing powers under the Law), then that information should not be given a lesser weight and no express discretion need be afforded to the AER to do so.

Second, the AER may disclose confidential information with the written consent of the person who gave it the information or the confidentiality claimant.[463] Where the AER considers that consultation in respect of particular information is required, it is open to the AER to propose a confidentiality regime (the terms of which are acceptable to the party submitting the document or the confidentiality claimant) to facilitate the granting of such consent. Confidentiality undertakings have been successfully used in the telecommunications context, where confidential information submitted by Telstra in regulatory processes under the then *Trade Practices Act 1974* (Cth) was accessed by interested parties on the basis of appropriate confidentiality undertakings. For example, the ACCC stated in a 2005 decision regarding access undertakings submitted by Telstra:[464]

> The ACCC recognises that its decision-making processes should be as transparent as practicable, and in this regard notes the opportunity for interested parties to obtain the commercial-in-confidence information from the provider of that information upon the giving of appropriate undertakings. The ACCC notes that interested parties have been able to negotiate such undertakings in respect of most of the confidential information that has been relied on by the ACCC.

Third, the AER is authorised to disclose information given to it in confidence to:

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[462] Section 28ZB(1) of the Law.

[463] Section 28X of the Law.

[464] ACCC, *Assessment of Telstra's ULLS and LSS monthly charge undertakings, Final Decision,* December 2005, pp13-4.

- any person authorised to perform or exercise a function or power on its behalf, including for instance its expert advisers and third party consultants;[465] and
- other regulatory bodies such as the ACCC, the AEMC, AEMO and state and territory regulators.[466]

Fourth and finally, the AER can disclose information under the existing provisions of the Law if it discloses the information in such a way as to conceal the identity of the person to whom the information relates.[467]

Summary

The Businesses consider that the existing Rules offer protection to NSPs submitting confidential information to the AER, while at the same time allow for transparency of decision making.

The AER's proposal to remove the distinction between NSP confidential information and confidential information submitted by other stakeholders, and to give itself discretion to accord lower weight to confidential information submitted by NSPs in regulatory proposals and revised regulatory proposals would not promote the NEO or be consistent with the RPPs.

The information submitted by the NSP the subject of the determination will necessarily be key information in the AER's determination of efficient expenditure forecasts. Giving the AER a discretion to accord reduced weight to confidential NSP information is undesirable as it would increase regulatory error by creating a risk that the AER would determine expenditure forecasts that do not adequately take confidential information into account, thereby curbing efficient investment in the network and preventing the recovery of efficient costs. The AER's proposed changes are also unnecessary because the AER can and does use its extensive information gathering powers to ensure the veracity of the information produced to it, and can adequately test confidential information within the constraints of the existing regime.

The Businesses submit that the existing framework in the Law and Rules strikes the correct balance between confidentiality and transparency and no change to the Rules is necessary.

C.4 FRAMEWORK AND APPROACH PAPER

AER Proposed Rule Change

Current Rule provisions

Under the current Rules, the AER is required to prepare and publish an F&A Paper in anticipation of every distribution determination.[468]

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[465] Section 18 of the Law, section 44AAF(6) of the CCA.

[466] Section 18 of the Law, section 44AAF(3) of the CCA, regulation 7 of the Competition and Consumer Regulations 2010.

[467] Section 28ZA of the Law.

[468] Clause 6.8.1(a) of the Rules.

The F&A Paper 'must state the form (or forms) of the control mechanisms to be applied by the distribution determination'.[469] At the distribution determination stage, the AER's decision on the control mechanism must then be in accordance with the relevant F&A Paper.[470]

The Rules also provide that the F&A Paper should address a range of matters, including the classification of distribution services (as direct control services or negotiated distribution services) and the application of the EBSS, STPIS and DMIS.[471] At the distribution determination stage, the classification of services must be as set out in the relevant F&A Paper unless the AER considers, based on the regulatory proposal and submissions received, 'there are good reasons for departing from the classification proposed in that paper'.[472] By contrast, the AER's decision on the application of each of the incentive mechanisms is not tied to the F&A Paper.[473]

AER's characterisation of 'the problem'

The AER submitted the following in respect of the existing Rule requirements regarding the F&A Paper:[474]

- there is not enough flexibility to amend the control mechanism as set out in the F&A Paper. The existing Rules go beyond what is required for regulatory certainty;
- by contrast, there is too much scope for amendments to be made to service classifications at the determination stage, which means there is insufficient regulatory certainty and potentially significant administrative costs to the NSPs and the AER (as changing service classifications require amendments to the opex and capex forecasts); and
- the requirement to consult on the application of incentive schemes at the F&A Paper stage in distribution is unnecessary and inefficient because the Rules provide for three stages of consultation on the development and application of each incentive scheme and there is a low level of stakeholder engagement at the F&A Paper stage (given the F&A Paper is not binding in this respect). As the application of incentive schemes is likely to change at the determination stage (once stakeholders are engaged with the subject matter), consultation at the F&A Paper stage offers limited benefit in terms of the level of regulatory certainty it can provide.

AER's proposed Rule changes

The AER proposed changes to the Rules to:[475]

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[469] Clause 6.8.1(c) of the Rules.

[470] Clauses 6.12.13(c), 6.12.1(11) and (12) of the Rules.

[471] Clause 6.8.1(b) of the Rules.

[472] Clause 6.12.3(b).

[473] Clause 6.12.1(9) of the Rules.

[474] AER Rule Change Proposal, pp92-4.

[475] AER Draft Rules, pp41, 51 (proposed clauses 6.8.1, 6.12.3(c)).

- provide for the AER to apply a control mechanism that differs from the control mechanism set out in the F&A Paper if, in light of the DNSP's regulatory proposal and the submissions received, the AER considers that there are circumstances that were unforeseen at the time the AER published the F&A Paper which justify a departure from the control mechanism specified in the Paper;

- amend the existing provision allowing the AER to depart from the classification of services in the F&A Paper if there are 'good reasons' for doing so to provide for the AER to depart from the classification of services in the F&A Paper if the AER considers that there are circumstances that were unforeseen at the time the AER published the F&A Paper which justify a departure; and

- remove the requirement for the AER to set out in the F&A Paper the application of each of the incentive schemes to the DNSP.

Businesses' Response

Introduction

The Businesses agree that the AER should have some flexibility to revisit the formulaic expression of the control mechanism at the determination stage. Indeed, the Businesses consider that the AER already has power under the existing Rules to make such amendments and note that the AER has itself amended the control mechanism formulas in past determinations.[476]

Accordingly, the Businesses have no concerns with amendments to the Rules to clarify that the formulaic expression of the control mechanism in the F&A Paper can be refined at the determination stage. However, to the extent the AEMC considers such clarification is necessary, the Businesses submit that, in contrast to the AER's proposal, there needs to continue to be a 'locking in' of the type of control mechanism that will be applied in the determination prior to the lodging of the regulatory proposal.

The Businesses also agree in principle with the AER's concerns as to the inefficiencies associated with the duplication of consultation at the F&A Paper and distribution determination stages. The Businesses consider, however, that further inefficiencies may arise in future and have proposed alternative amendments to the Rules.

The Businesses do not wish to make specific submissions at this stage as to the AER's proposal to amend the AER's power to change the classification of services from those set out in the F&A Paper or to remove the requirement for the AER to address in the F&A Paper the application of each of the incentive schemes to the DNSP.

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[476] Compare the form of control mechanism in Appendix D of the AER's *Final Framework and Approach Paper, ETSA Utilities, 2010-15,* November 2008 and the control mechanism in section 4.4 of the AER's South Australian Distribution Determination Final Decision (in particular, see the additional pass through term); compare the form of control mechanism in Appendix F of the AER's *Final framework and approach paper for Victorian electricity distribution regulation, Regulatory control period commencing 1 January 2011*, May 2009 and section 4.5.1 and Appendix E of the AER's Victorian Distribution Determinations Final Decision (in particular, see the additional pass through term, the definition of CPI and the licence fee factor definition). See also page 45 of the AER's South Australian Distribution Determination Draft Decision where the AER stated: 'the AER considers that the WAPC formula can be amended where this would reflect (or better reflect) the reasoning set out in the framework and approach').

The type of control mechanism to be applied should be locked in prior to the submission of the regulatory proposal

The current Rules provide for significant flexibility as to the type of the control mechanism that may be applied to DNSPs. The control mechanism may consist of a schedule of fixed prices, caps on the prices of individual services, caps on the revenue to be derived from a combination of services, a tariff basket price control, revenue yield control or a combination of any of these.[477]

Under the AER's proposed Rules, the power of the AER to change the control mechanism applicable to a DNSP between the F&A Paper and the final distribution determination is not limited to changes to address 'issues of lower order detail'. Rather, it extends to fundamentally changing the type of the control mechanism (for example, from a tariff basket price control at the F&A Paper stage to a revenue cap at the determination stage).

This creates an unacceptable degree of regulatory uncertainty for DNSPs. The possibility of such a significant change to the control mechanism occurring after DNSPs have submitted their initial regulatory proposals would impose a prohibitive administrative burden on them, particularly given the temporal constraints in place after the regulatory proposals have been submitted.

Regulatory certainty was the driver of the original decision to 'lock in' the control mechanism at the F&A Paper stage. The relevant provision was introduced into Chapter 6 by the SCO in response to concerns on the part of the regulator and NSPs that the release of an issues paper does not provide sufficient certainty and guidance in order for the DNSP to put forward its regulatory proposal on an agreed set control mechanisms.[478] The SCO responded by requiring the AER to set out in its F&A Paper the form of control to be applied at least 18 months prior to the expiry of the distribution determination.[479] The Businesses consider that this important objective can be achieved, while affording the AER flexibility to make minor amendments to the control mechanism at the determination stage, if the AER is required to lock in only the type of control mechanism at the F&A Paper stage.

By providing the AER with the power to fundamentally change the control mechanisms at any time before the final distribution determination, the AER's proposed Rule change may also constrain the DNSPs' ability to properly assess any new proposed type of control mechanism. If the AER changed the type of control mechanism to be applied after a DNSP submitted its regulatory proposal, the DNSP would have limited opportunity to reflect upon and properly understand the implications of the mechanism. Any innovative, complex control mechanism can take a DNSP and its management a long period of time to fully understand. DNSPs need sufficient time to consider and reflect upon any new control mechanism to ensure that any unintended and perverse outcomes that may result from the introduction of that mechanism are avoided, and to properly consider the impact of the type of the control mechanism on other parts of their regulatory proposals. For example, in South Australia, in the last determination made by ESCOSA, ESCOSA implemented an average

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[477] Clause 6.2.5(b) of the Rules.

[478] SCO, *Table 1: SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, 1 August 2007, p44.

[479] SCO, *Table 1: SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, 1 August 2007, p45. The Rules as made provided that the F&A Paper must the F&A Paper at least 19 months before the end a regulatory control period.

revenue cap which included a 'Q factor' to correct for forecasting errors in total sales.[480] This had implications for other parts of the decision. In particular, the reduction in volatility of ETSA Utilities' returns reduced its systematic (non-diversifiable) risk, and thus had implications for the required rate of return (specifically, the equity beta).[481]

There is scope to increase efficiencies beyond those addressed by the AER's proposed Rule changes

As noted above, the Businesses agree in principle with the AER's concerns as to the inefficiencies associated with the duplication of consultation arising due to the scope of the F&A Paper. Rather than addressing only the inefficiencies that have arisen in the past, however, the Businesses consider any amendment to the Rules should seek to remove the potential for inefficiencies arising in the future.

As issues regarding control mechanisms and service classification become more settled over time, it may be that no F&A Paper is necessary and requiring the AER to publish an F&A Paper would be inefficient. Accordingly, the Businesses consider that making the F&A Paper optional where there is a distribution determination on foot and there are no dual function assets[482], with either the AER or the NSP initiating an F&A Paper consultation process if necessary, would address potential future inefficiencies associated with the publication of the F&A Paper and thus further promote the NEO.

The Businesses consider that the Rules need only include a requirement to publish an F&A Paper where:

- there is no distribution determination on foot;
- the DNSP owns, controls or operates dual function assets;
- either the DNSP or the AER consider that a control mechanism and/or service classification that differs in a material respect from the control mechanism and/or service classification in the distribution determination in force ought to apply; or

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[480] ESCOSA, *2005-2010 Electricity Distribution Price Determination, Part A, Statement of Reasons*, April 2005, section 12.8.1.

[481] ESCOSA, *2005-2010 Electricity Distribution Price Determination, Part A, Statement of Reasons*, April 2005, p142; ESCOSA, *2005-2010 Electricity Distribution Price Determination, An application by ETSA Utilities for a review pursuant to section 31 of the Essential Services Commission Act 2002, Decision and reasons for decision*, 31 May 2005, pp39-40. In the context of considering ETSA Utilities' request that it review its decision on the tariff rebalancing control, ESCOSA also explicitly considered the impact of the 'Q factor' on the maximum average distribution revenue (and thus the rebalancing constraint): ESCOSA, *2005-2010 Electricity Distribution Price Determination, An application by ETSA Utilities for a review pursuant to section 31 of the Essential Services Commission Act 2002, Decision and reasons for decision*, 31 May 2005, pp63-5.

[482] Clause 6.8.1(ca) of the Rules provides that the F&A Paper must include the AER's determination under clause 6.25(b) as to whether or not Part J of Chapter 6A is to be applied to determine the pricing of transmission standard control services by any dual function assets owned, controlled or operated by the DNSP. Clause 6.25(b) of the Rules provides that the AER must, following consultation in the course of preparing the F&A Paper, determine whether the value of the DNSP's dual function assets comprise such a material proportion of that DNSP's RAB that pricing in respect of those services should be regulated under Part J of Chapter 6A. The F&A Paper will therefore continue to be required for the purposes of these provisions where a DNSP owns, controls or operates dual function assets.

- either the DNSP or the AER considers that an adjustment to provide for the fair sharing of the profits from the provision of services other than standard control services using assets forming part of the RAB between the DNSP and the users may be required.

Businesses' alternative proposed amendments to the Rules

As noted above, the Businesses agree that the AER should have some flexibility to revisit the formulaic expression of the control mechanism at the determination stage. However, the Businesses consider that some certainty as to the type of control mechanism to be applied should continue to be provided under the Rules. That is, the discretion accorded to the AER to depart from the control mechanisms in the F&A Paper should be confined to departures relating to formulaic expression. Proposed alternative drafting of clause 6.12.3(c) is set out below.

The Businesses also consider that making the F&A Paper optional where there is a prior distribution determination on foot and there are no dual function assets, with either the AER or the NSP initiating a process if necessary, would address potential future inefficiencies associated with the publication of the F&A Paper and thus further promote the NEO. The Businesses propose amendments to clause 6.8.1 of the Rules to provide that an F&A Paper need only be prepared if there is no distribution determination on foot, the DNSP owns, controls or operates dual function assets or either the AER or the DNSP give notice to the other at least 25 months before the expiry of the distribution determination that they consider:

- a control mechanism and/or service classification that differs in a material respect from the control mechanism and/or service classification in the distribution determination in force ought to apply; or

- an adjustment to provide for the fair sharing of the profits from the provision of services other than standard control services using assets forming part of the RAB between the DNSP and the users may be required.

The Businesses also propose to limit the scope of the F&A Paper to matters in contention. Consequential amendments to reflect the above are required to clause 6.12.3(b) and (c) of the Rules.

The Businesses proposed drafting amendments are set out below.

Summary

The Businesses share the AER's desire to reduce inefficient consultation required by the Rules.

However, the AER's proposal does not limit the changes to the control mechanism that can be made at the distribution determination stage. As a result, the AER's proposal would reduce regulatory certainty as to the form of the control mechanism to be applied and would increase administrative costs to DNSPs and the AER. The Businesses' proposed change provides the AER with the flexibility to make changes to the formulaic expression of the control mechanism to better respond to issues raised at the distribution determination stage, while maintaining regulatory certainty as to the type of the control mechanism to be applied. The Businesses' alternative proposed Rule changes therefore promote the NEO and the RPPs.

As to reducing the inefficiencies associated with the F&A Paper process, the Businesses consider that the ENA's proposed amendments should be preferred to the AER's, for the reasons outlined by the ENA. The Businesses observe, that regardless of which (if any) approach the AEMC is minded to adopt, it would promote the NEO if it was clear that the AER was permitted to amend the

formulaic expression of the control mechanism at the determination stage but was required to adopt the type of control mechanism specified in its F&A Paper.

6.8.1 AER's framework and approach paper

(a) The *AER* must prepare and *publish* a document (a *framework and approach paper*) in anticipation of ~~every~~ a distribution determination if:

(1) no distribution determination applies to the service provider;

(2) the *Distribution Network Service Provider* owns, controls or operates *dual function assets*; or

(3) notice is given under paragraph (a1).

(a1) The *AER* or the *Distribution Network Service Provider* may, no later than 25 months before the end of the current *regulatory control period*, give notice to the other that it considers:

(1) a control mechanism that differs in a material respect from the control mechanism in the distribution determination currently in force ought to apply; or

(2) classification of *distribution services* in accordance with Part B that differs in a material respect from the classification in the distribution determination currently in force ought to apply; or

(3) an adjustment for the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than *standard control services* in the control mechanism or by an adjustment to the building blocks as referred to in clause 6.4.3(a)(8) or a combination of these adjustments may be required.

(b) The *framework and approach paper* should set out the *AER's* likely approach (together with its reasons for the likely approach), in the forthcoming distribution determination, to:

(1) if no distribution determination applies or if it was the subject of notice under paragraph (a1), the classification of *distribution services* in accordance with Part B; and

~~(2) the application to the *Distribution Network Service Provider* of a *service target performance incentive scheme* or *schemes*; and~~

~~(3) the application to the *Distribution Network Service Provider* of an *efficiency benefit sharing scheme* or *schemes*; and~~

~~(4) the application to the *Distribution Network Service Provider* (if applicable) of a *demand management incentive scheme* or *schemes*; and~~

~~(2) whether there is to be an adjustment for the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than the provision of *standard control services* in the control mechanism or by an adjustment to the building blocks as referred to in clause 6.4.3(a)(8) or a combination of these adjustments; and~~

~~(3)~~(2) if no distribution determination applies or if it was the subject of notice under paragraph (a1), the form (or forms) of the control mechanisms to be applied by the distribution determination and the *AER's* reasons for deciding on control mechanisms of the relevant form (or forms); and

(3) if no distribution determination applies or if it was the subject of notice under paragraph (a1), any adjustment for the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than the provision of *standard control services*; and

~~(5)~~(4) any other matters on which the *AER* thinks fit to give an indication of its likely approach.

~~(c) The *framework and approach paper* must state the form (or forms) of the control mechanisms to be applied by the distribution determination and the *AER's* reasons for deciding on control mechanisms of the relevant form (or forms).~~

(ca) The *framework and approach paper* must include the *AER's* determination under clause 6.25(b) as to whether or not Part J of Chapter 6A is to be applied to determine the pricing of *transmission standard control services* provided by any *dual function assets* owned, controlled or operated by the *Distribution Network Service Provider*.

(d) A *framework and approach paper* is to be prepared in consultation with the relevant *Distribution Network Service Provider* and with other interested stakeholders.

(e) The *AER* should complete its *framework and approach paper* for a particular *distribution network* sufficiently in advance of the making of the relevant distribution determination to enable it to be of use to the *Distribution Network Service Provider* in preparing its *regulatory proposal*.

(f) If a distribution determination is currently in force, the *AER* must commence preparation of, and consultation on, the *framework and approach paper* for the distribution determination that is to supersede it at least 24 months before the end of the current *regulatory control period* and must complete preparation at least 19 months before the end of that *regulatory control period*.

(g) On completing its *framework and approach paper*, the *AER* must:

(1) give a copy to the *Distribution Network Service Provider*; and

(2) *publish* it.

(h) Subject to clause 6.12.3, a *framework and approach paper* is not binding on the *AER* or a *Distribution Network Service Provider*.

…

6.12.3 Extent of AER's discretion in making distribution determinations

…

(b) The classification of services must be as set out in the relevant *framework and approach paper* or previous distribution determination unless the *AER* considers that, in the light of the *Distribution Network Service Provider's regulatory proposal* and the submissions received, there are ~~good reasons for departing~~circumstances that were unforeseen at the time the *AER published* the relevant *framework and approach paper* or previous distribution determination which justify a departure from the classification ~~proposed~~ specified in that paper or determination.

(c) The form of the control mechanisms must be as set out in the relevant *framework and approach paper* or previous distribution determination ~~unless the *AER* considers that, in the light of the *Distribution Network Service Provider's regulatory proposal* and the submissions received, there are circumstances that were unforeseen at the time the *AER published* the relevant *framework and approach paper* which justify a departure from the control mechanisms specified in that paper~~. The AER may make such changes to the formulaic expression of the control mechanisms as are required to address matters raised in respect of the formulaic expression of the control mechanisms in submissions to the AER in accordance with clause 6.9.3, 6.10.2, 6.10.3 or 6.10.4 or the *regulatory proposal* or revised *regulatory proposal*.

…

C.5 CORRECTING FOR MATERIAL ERRORS

AER Proposed Rule Change

Current Rule provisions

The current Rules provide that the AER may only revoke a distribution determination if it appears to the AER that the determination is affected by a material error or deficiency of one or more of the following kinds:[483]

- a clerical mistake or an accidental slip or omission;
- a miscalculation or misdescription;
- a defect in form; and
- a deficiency resulting from the provision of false or materially misleading information to the AER.

AER's characterisation of 'the problem'

The AER expressed concern that material errors may arise in the making of a distribution determination that fall outside of the exhaustive list of errors currently identified in the Rules.[484]

The AER also stated that, while it currently has powers to 'revoke and substitute' an entire distribution determination, 'it is conceivable there may be circumstances where it is more appropriate or preferable to [amend the determination]'.[485]

AER's proposed Rule changes

The AER's proposed Rule changes to remove the limitations on its ability to revoke a determination by reference to the character of error or deficiency and provide that it may revoke a distribution determination where:[486]

- the annual revenue requirement was set on the basis of information that was false or misleading in a material particular; or
- there was a material error or deficiency in the determination.

The AER also proposed to include a power for it to 'amend' determinations in the same circumstances.

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[483] Clause 6.13(a) of the Rules.

[484] AER Rule Change Proposal, pp95-6.

[485] AER Rule Change Proposal, p96.

[486] AER Draft Rules , p52 (proposed clause 6.13(a)).

Businesses' Response

Introduction

The Businesses reject the AER's proposed Rule changes on the basis they would significantly reduce regulatory certainty and eliminate finality in decision-making, with adverse consequences for efficiency and investment in networks. The Businesses do not consider there to be any associated benefit with the change - while the Rules in their current form may lead to certain errors going uncorrected, the limitations on the AER's ability to correct for material errors are just as likely to operate to advantage and disadvantage the DNSP the subject of the determination.

It is also not clear to the Businesses why the AER requires a power to 'amend' determinations, rather than relying on its power to revoke and substitute.

Certainty and finality of decision-making required

The Businesses consider that certainty and finality of decisions, including clarity as to the circumstances in which revocation of the decision can occur, is essential in ensuring effective regulation. As noted by the AEMC in its 2006 Transmission Rule Determination:[487]

> [T]he circumstances under which the AER may revoke and remake a revenue cap determination should be clearly set out in the Rules in order to increase the certainty and transparency associated with the regulatory framework and to maintain the incentives built into that framework.

The incentives built into the framework arise from the form of economic regulation contemplated by the Rules (that is, incentive regulation rather than cost-of-service regulation). The AEMC has described this form of regulation as follows:[488]

> While cost-of-service regulation is based on remunerating TNSPs in respect of their *actual* costs, incentive regulation is based on remunerating TNSPs in respect of their *forecast* costs over the regulatory control period (which is typically three to five years). Because TNSPs are able to capture a proportion of the benefits of any unanticipated cost reductions (and must absorb unanticipated cost increases) that occur during a regulatory control period, they are encouraged to make cost savings. At the end of the period, the actual costs in this period may be used as a *basis* for establishing the reasonableness of the cost estimates provided by the TNSP in the subsequent regulatory period. In this way consumers share the benefits of the efficiency gains secured by the TNSP, just as in a competitive market costs savings are ultimately passed to customers as lower prices.

A far-reaching discretion to revoke and substitute or amend a determination (in place of the narrow list of circumstances in which a determination can be revoked under the existing Rules) would significantly reduce DNSPs' certainty as to regulated revenues in a given regulatory control period. Without certainty as to revenue amounts, DNSPs would have reduced incentives to achieve efficiencies as the benefits they may capture as a result are unknown.

An absence of certainty as to revenue would also impact on DNSPs' willingness to undertake efficient investments or to increase expenditure in order to operate the network efficiently. Even if the expenditure was approved by the AER in the final determination, the possibility of the AER reducing revenue allowances on the basis of error (broadly defined), would likely deter NSPs from undertaking this expenditure in full.

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[487] 2006 TNSP Rule Determination, p122.

[488] 2006 TNSP Rule Determination, p93.

To reduce the uncertainty associated with a power to revoke or amend a determination (and thus reduce the impact on expenditure incentives), the Businesses submit that the circumstances in which a determination can be revoked or amended should, as they currently are, be clearly set out in the Rules.

The Businesses also submit that the circumstances in which a determination can be revoked or amended should be limited to the kinds of errors that are currently identified in clause 6.13(a), namely errors that are clerical or an accidental slip or omission, a miscalculation or misdescription, a defect in form or a deficiency resulting from the provision of false or misleading information to the AER. The Businesses do not consider that the AER should be permitted to revoke or amend a determination simply on the basis of forecasting error or deficiencies in an element of the determination that was the subject of a deliberate decision by the AER. If such a proposal were adopted, DNSPs could be exposed to ad hoc adjustments made by the AER at any time to correct for errors made by it in determining its 'best' estimate. For example, the AER may determine in subsequent review processes that an opex forecasting methodology different to that used in its determination in respect of ETSA Utilities produces the most accurate forecasts and seek to correct for this 'error' or 'deficiency' in its final determination in respect of ETSA Utilities. As noted above, this would reduce the incentives on NSPs to achieve efficiencies generally associated with the CPI-X regulatory framework and would discourage efficient levels of expenditure (even where determined by the AER in its determination).

The AER recognises that finality of decision-making is important to the regulatory process. It was for this reason that it proposed to remove the AER's ability to change a final transmission determination by more than the extent necessary to correct for an error.[489] It was also for this reason that the AER proposed a defined materiality threshold for cost pass through events in chapter 6.[490]

AER's power to 'amend' unnecessary

The AER has not substantiated the need for a power to 'amend' determinations rather than revoking and substituting, other than to note 'it is conceivable there may be circumstances where it is more appropriate or preferable to do so rather than to "revoke and substitute" the entire distribution or transmission determination'[491] and that its proposal reduces uncertainty by 'providing the AER with the flexibility to amend, instead of revoking and substituting'.[492]

Given under the existing Rules the AER can only vary the substituted determination to the extent necessary to correct the relevant error or deficiency,[493] there is no increased certainty resulting from an 'amendment' rather than revocation and substitution. It is not clear to the Businesses what circumstances could mean that it was more appropriate to 'amend' rather than revoke and substitute. The processes that AER would need to undertake in order to make either would appear to be the same, and thus no efficiencies can be achieved by the change.

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[489] AER Rule Change Proposal, pp95-6.

[490] AER Rule Change Proposal, p49.

[491] AER Rule Change Proposal, p96.

[492] AER Rule Change Proposal, p97.

[493] Clause 6.1.3(c) of the Rules.

Summary

As they increase the uncertainty as to the revenue allowances over the regulatory control period, the AER's proposed Rule changes are contrary to the NEO and the RPPs. They reduce the incentives on regulated NSPs to take measures to reduce expenditure and have the potential to deter efficient capex on networks and efficient increases in opex. The existing Rules, with clearly specified and limited scope to revoke determinations, provide greater regulatory certainty and thus promote the NEO and are consistent with the RPPs.

C.6 TIMEFRAME FOR THE CONDUCT OF WACC REVIEWS

AER Proposed Rule Change

Current Rule provisions

The Rules in their current form provide that the AER is to undertake a review of the WACC parameters in accordance with the 'distribution consultation procedures'.[494] These procedures provide as follows:[495]

- the AER must publish its proposal, together with an explanatory statement and an invitation for written submissions. The AER must allow at least 30 business days for the making of submissions;
- the AER may publish such issues, consultation and discussion papers and hold such conferences and information sessions as it considers appropriate; and
- within 80 business days of publishing its proposal and explanatory material, the AER must publish its final decision, together with the reasons for the decision. The AER may extend the time within which it is required to publish its final decision if the consultation involves questions of unusual complexity or difficulty, or the extension of time has become necessary because of circumstances beyond the AER's control.

AER's characterisation of 'the problem'

The AER raised concerns with the application of the 'distribution consultation procedures' to the WACC review required by clause 6.5.4 (d) of the Rules.

Specifically, the AER submitted that the existing 80 business day timeframe from the publication of the AER's proposal, explanatory statement and invitation for submission to the publication of the AER's final decision does not allow enough time for a review of the WACC given the complexity and significance of the task.[496]

The AER further noted that, while it is has some flexibility to extend this timeframe under Chapter 6, it has no such flexibility under the analogous provisions in Chapter 6A. This means that

[494] Clause 6.5.4(a) of the Rules.

[495] Clause 6.16 of the Rules.

[496] AER Draft Rule Proposal, p97.

in the context of an electricity-wide WACC review, the AER is constrained in its ability to extend the timeframe.[497]

AER's proposed Rule changes

The AER proposed a new Rule to amend the distribution consultation procedures as they apply to a review of the WACC. The AER proposed an amendment to provide that the reference to 80 business days be read as a reference to 100 business days.[498] The AER stated this would 'ensure the continued thorough analysis in the review and permit the AER to set a longer consultation period for stakeholders, where warranted'.[499]

In recognition of the need for timeliness of decision making and investment certainty, the AER also proposed removing the ability to extend the time within which it is required to publish a final decision after a WACC review.[500]

Businesses' Response

The Businesses agree that a consultation period longer than 80 business days is required in order to reduce the scope for regulatory error when the AER undertakes a WACC review. However, just as the complexity and significance of the matters in issue mean the AER requires a longer period, so too do stakeholders require additional time to properly assess and respond to the AER's proposal and thereby reduce the risk of regulatory error.

The AER's proposed Rule changes increase the total period of time available to the AER to make its final decision, without a corresponding increase in the period of time stakeholders are given to make submissions. Allowing sufficient time for stakeholders to respond to the AER's proposal is vital to reducing the risk of regulatory error. Given the technical and complex subject matter, stakeholders inevitably need to engage third party experts to assist in reviewing the AER's proposal and providing a response. This will often require a period of longer than 30 business days and can be particularly difficult over the Christmas and New Year period, during which time third party experts are often not available.

The Businesses therefore propose that, in conjunction with increasing the total time for the making of the AER's final decision after its proposal is released (from 80 business days to 100 business days), the Rules be amended to:

- increase the total time for the making of stakeholder submissions from 30 business days to 45 business days; and
- exclude from the definition of 'business days' the period from 25 December to 14 January.

The Businesses' proposed amendments to the AER Draft Rules regarding the application of the distribution consultation procedures to the WACC review are set out below.

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[497] AER Draft Rule Proposal, p97.

[498] AER Draft Rules, p20 (proposed clause 6.5.4(a)(1)).

[499] AER Rule Change Proposal, p98.

[500] AER Rule Change Proposal, p98; AER Draft Rules, p20 (proposed clause 6.5.4(a)(2)).

Summary

The Businesses agree with the AER that a longer timeframe is required in order to allow thorough analysis to take place prior to the AER's final decision. However, the additional time should not solely be reserved for the AER.

An extended timeframe for the AER's WACC review, where this involves an increase to both the timeframe for the making of stakeholder submissions and the making of the AER's final decision, would promote the NEO and is consistent with the RPPs as it facilitates a thorough analysis of the materials and is more likely to ensure the NSPs recover their efficient costs of capital.

6.5.4 Review of rate of return

(a) The *AER* must~~, in accordance with the *distribution consultation procedures* and this clause,~~ carry out reviews of the matters referred to in paragraph (d)~~.~~ in accordance with this clause and the *distribution consultation procedures*, subject to:

(1) the reference in rule 6.16(c) to 30 *business days* being read as a reference to 45 *business days*; and

~~(1)~~(2) the reference in rule 6.16(e) to 80 *business days* being read as a reference to 100 *business days*; and

(3) each day in the period 25 December to 14 January being excluded from the calculation of the number *business days* in rule 6.16(c) and 6.16(e); and

~~(2)~~(4) the *AER* may not extend this time within which it is required to publish its final decision under rule 6.16(g).

...

C.7 TIMEFRAME FOR ASSESSMENT OF PASS THROUGH EVENTS, CONTINGENT PROJECTS AND CAPEX REOPENERS

AER Proposed Rule Changes

Current Rule provisions

Under the current Rules, if the AER does not make a determination as to the amount that should be passed through to a DNSP in response to a DNSP application for a positive pass through amount within 60 business days, the AER is taken to have determined the pass through amount as proposed by the DNSP.[501]

For capex reopener applications (which currently exist only in respect of transmission determinations, but which the AER proposes to introduce in respect of distribution determinations), the Rules require the AER to make a decision on the application within 60 business days of the application being made.[502] Similarly, for contingent project applications (which currently exist only in respect of transmission determinations, but which the AER proposes to introduce in respect of distribution determinations), the Rules require the AER to make a decision on the application within 30 business days.[503]

AER's characterisation of 'the problem'

The AER expressed concern that the existing provisions governing applications in respect of positive pass through amounts, contingent projects and capex reopeners do not allow the AER sufficient time for a thorough assessment of complex applications. The AER noted in particular that it has no power to extend the periods where the applications involve questions of unusual complexity of difficulty.[504]

AER's proposed Rule changes

The AER proposed amendments to the Rules to:[505]

- change the timeframe for the making of AER decisions on applications in respect of positive pass through events, contingent projects and capex reopeners to within 40 business days of the receipt of the application; and
- give the AER power to extend this timeframe by up to an additional 60 business days if the assessment involves questions of unusual complexity or difficult or the AER requires further information.

The AER's proposed new clause to provide for the reopening of a distribution determination for capital expenditure was consistent with the above (i.e. it required a decision within 40 business days

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[501] Clause 6.6.1(e) of the Rules.

[502] Clause 6A.7.1(c) of the Rules.

[503] Clause 6A.8.2(d) of the Rules.

[504] AER Rule Change Proposal, pp99-100.

[505] AER Draft Rules, pp30, 32 (proposed clauses 6.6.1(e), 6.6.1(l)).

of an application being made, and provided for an extension by up to a further 60 business days if it involved questions of unusual complexity or difficulty or the AER requires further information).[506]

Businesses' Response

The Businesses observe that, as noted in section A3 of Annexure A above, they oppose the AER's proposed amendments to introduce capex reopeners and contingent projects into the distribution regulatory framework in Chapter 6 of the Rules.

The Businesses consider that pass through applications will, in most instances, be complex and be related to administrative processes (such as government inquiries), and thus will almost always take longer than 40 business days to consider and consult on. The Businesses note for example, Powercor Australia is likely to lodge pass through applications regarding the implementation of the recommendations of the VBRC and the impact of the impending carbon legislation, both of which will be complex and require extensive consultation.

To facilitate and ensure increased consultation on pass through applications, the Businesses propose amendments to the AER's Rule change to:

- require the AER to publish a draft decision prior to making any pass through decision (proposed clause 6.6.1(i1)) and to consult on that draft decision (proposed clause 6.6.1(i2)); and

- permit the AER to 'stop-the-clock' where it has requested and is awaiting information from third parties or the DNSP that submitted the application or where an administrative process which is likely to impact on the assessment or quantification of the effect of the relevant pass through event is being conducted (proposed clauses 6.6.1(l) to (o)).

The Businesses' proposed amendments to the AER Draft Rules are set out below.

Summary

The Businesses agree that a change in the Rules to allow extended periods within which to consult and gather information to assess complex pass through applications is required. However, the AER's proposal accords significant discretion to the regulator to extend the timeframe, while at the same time providing a hard end date that cannot be extended in any circumstances. The Businesses consider that, as a result, the AER's proposed approach may prevent the AER from determining efficient levels of investment and efficient costs associated with operating the network.

The Businesses submit that requiring the AER to consult by requiring a draft determination, and to allow the AER a 'stop the clock' mechanism, under which the AER has the power to exclude from the calculation of the timeframe for the making of decision those periods during which it is waiting on information from third parties, better promotes the NEO and the RPPs by:

- ensuring interested parties (including the DNSP the subject of the determination) are presented with a reasonable opportunity to make submissions on the determination; and

- limiting the AER's discretion to extend the period for the making of its decision to those circumstances where it requires additional information, while ensuring that it has the

[506] AER Draft Rules, pp34-5 (proposed clauses 6.6.4(c)(2), 6.6.4(h)).

flexibility to extend the timeframe for the making of its decision beyond 100 business days where it is necessary to do so.

6.6 Adjustments after making of building block determination.

6.6.1 Cost pass through

…

Consultation and publication of draft determination

(i) Before making a determination under paragraph (d) or (g), the *AER* may either or both:

(1) consult with the relevant *Distribution Network Service Provider* and such other persons as the *AER* considers appropriate;

(2) *publish* an invitation for written submissions within a specified period,

on any matters arising out of the relevant pass through event the *AER* considers appropriate.

(i1) Before making a determination under paragraph (d) or (g), the *AER* must *publish*:

(1) a draft determination; and

(2) the notice of the making of the draft determination; and

(3) the *AER's* reasons for suggesting that the determination should be made as proposed; and

(4) an invitation for written submissions on its draft determination.

(i2) Any person may make a written submission to the *AER* on the draft determination within the time specified in the invitation referred to in paragraph (i1)(4), which must be not earlier than 30 *business days* after the making of the draft determination.

…

Extension of time limits and stopping the clock

(k) The *AER* must, by written notice to a *Distribution Network Service Provider*, extend a time limit fixed in clause 6.6.1(c) or clause 6.6.1(f) if the *AER* is satisfied that the difficulty of assessing or quantifying the effect of the relevant *pass through event* justifies the extension.

(l) The *AER* may extend the time limit fixed in clause 6.6.1(e) by up to a further 60 *business days* if:

(1) making the determination involves questions of unusual complexity or difficulty; or

(2) the *AER* requires information further to that specified in the *Distribution Network Service Provider's* written statement submitted under clause 6.6.1(c).

(m) Subject to paragraph (n), in calculating the period under paragraph (e), the *business days* in the following periods must be disregarded:

(1) if the *AER publishes* an invitation for written submissions under paragraph (i)(2) or (i1)(4), the period from the date the invitation was *published* to the time specified in the invitation for the making of those submissions (inclusive);

(2) if the *AER* requests further information from the *Distribution Network Service Provider*, the period from the date the request is made by the *AER* to the date a response to the request is provided by the *Distribution Network Service Provider* (inclusive); and

(3) any period during which an administrative process which is likely to impact on the assessment or quantification of the effect of the relevant *pass through event* is being conducted.

(n) Despite paragraph (m), any *business day* can only be disregarded if the *AER* has first given written notice to the *Distribution Network Service Provider* that the time under paragraph (e) has stopped.

(o) The *AER* must, by written notice as soon as practicable after the end of any period under paragraph (m), advise the *Distribution Network Service Provider* of the period during which the *business days* are to be disregarded under that paragraph.

ANNEXURE D - INDEX OF ATTACHMENTS

Attachment	Description
1	AEMC, *Draft Rule Determination, Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, 26 July 2006
2	AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006
3	AER, *Electricity Transmission and Distribution Network Service Providers, Statement of the Revised WACC Parameters (Transmission), Statement of Regulatory Intent on the Revised WACC Parameters (Distribution)*, May 2009
4	AER, *Final Decision, Electricity Transmission and Distribution Network Service Providers Review of the Weighted Average Cost of Capital (WACC) Parameters*, May 2009
5	AER, *Rule Change Proposal, Economic Regulation of Transmission and Distribution Network Service Providers, AER's Proposed Changes to the National Electricity Rules, Part C - Draft Rules*, September 2011
6	AER, *Rule Change Proposal, Economic Regulation of Transmission and Distribution Network Service Providers, AER's Proposed Changes to the National Electricity Rules*, September 2011
7	CitiPower, *Regulatory Proposal: 2011 to 2015*, 30 November 2009
8	CitiPower, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010
9	ETSA Utilities, *Regulatory Proposal 2010-2015*, 1 July 2009
10	ETSA Utilities, *Revised Regulatory Proposal 2010-2015*, 14 January 2010
11	Powercor Australia, *Regulatory Proposal: 2011 to 2015*, 30 November 2009
12	Powercor Australia, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010
13	SCO, *SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, accompanying SCO's *Energy Market Reform Bulletin No. 95* dated 1 August 2007
14	SCO, *Energy Market Reform Bulletin No. 95*, 1 August 2007
15	*Application by EnergyAustralia and Others* [2009] ACompT 8 (12 November 2009)
16	AER, *Final Decision, Envestra Ltd Access Arrangement Proposal for the SA Gas Network 1 July 2011-30 June 2016*, June 2011
17	AER, *Final Decision, Envestra Ltd Access Arrangement Proposal for the Qld Gas Network 1 July 2011-30 June 2016*, June 2011

18	*ActewAGL Distribution v The Australian Energy Regulator* [2011] FCA 639
19	AER, *Final Decision, South Australia Distribution Determination 2010-11 to 2014-15*, May 2010
20	AER, *Final Decision, Queensland Distribution Determination 2010-11 to 2014-15*, May 2010
21	AER, *Final Decision, Victorian Electricity Distribution Network Service Providers Distribution Determination 2011-2015*, October 2010
22	*Application by Energex Limited (No 2)* [2010] ACompT 7 (13 October 2010)
23	*R v Hunt; Ex parte Sean Investments Pty Ltd* (1979) 180 CLR 322
24	*R v Toohey; Ex parte Meneling Station Pty Ltd* (1982) 158 CLR 327
25	*Craig Williamson Pty Ltd v Barrowcliff* [1915] VLR 450
26	*K&S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd* (1985) 60 ALR 509
27	Chapter 4 from Pearce and Geddes, *Statutory Interpretation in Australia*, 7th Edition, LexisNexis Butterworths, 2011
28	Letter from Mr Eric Lindner, General Manager Regulation, ETSA Utilities to Mr Adam Peterson, Director - Network Regulation South, AER, 28 August 2009
29	Letter of advice from Dr Michael O'Rourke, Counsel, AGS to Mr Anthony Goh, Senior Lawyer, ACCC, 'Advice on possible amendments to the National Electricity Rules', 27 September 2011
30	Letter from Mr Richard Gross, General Manager Regulation and BDI, CitiPower and Powercor Australia to Mr Chris Pattas, General Manager, Network Regulation South Branch, AER, 'Victorian Bushfire Royal Commission - implications of Final Report for the EDPR', 19 August 2010
31	CitiPower and Powercor Australia, *Submission on the AER's draft distribution determination 2011-2015, Appendix P: Debt raising costs*, 19 August 2010
32	Statement of Julie Marie Williams, 19 August 2010 (public version)
32C	**CONFIDENTIAL -** Statement of Julie Marie Williams, 19 August 2010
33	AER, *Market Notice*, 30 March 2010 (screenshot)
34	Chapter 19 from Pearce and Argument, *Delegated Legislation in Australia*, 3rd Edition, LexisNexis Butterworths, 2005
35	ACCC, *Assessment of Telstra's ULLS and LSS monthly charge undertakings, Final Decision*, December 2005
36	AER, *Final Framework and Approach Paper ETSA Utilities 2010-15*, November 2008

37	AER, *Final Framework and Approach Paper for Victorian Electricity Distribution Regulation, CitiPower, Powercor, Jemena, SPAusNet and United Energy, Regulatory Control Period Commencing 1 January 2011*, May 2009
38	AER, *Final Decision - Appendices, Victorian Electricity Distribution Network Service Providers Distribution Determination 2011-2015*, October 2010
39	AER, *Draft Decision, South Australia Draft Distribution Determination 2010-11 to 2014-15*, 25 November 2009
40	*Application by Energex Limited (Distribution Ratio (Gamma)) (No 3)* [2010] ACompT 9 (24 December 2010)
41	*Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9 (12 May 2011)
42	*Application by ActewAGL Distribution* [2010] ACompT 4 (17 September 2010)
43	*Application by Jemena Gas Networks (NSW) Ltd (No 5)* [2011] ACompT 10 (9 June 2011)
44	MCE, *Distribution Network Planning and Expansion Framework Rule Change Request*, January 2011
45	EURCC, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt*, 17 October 2011
46	CEPA, *Rule Change Sub-Committee of Energy Users Association Australia, Estimating the Debt Margin, Final Report*, October 2011
47	Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy*, April 2006
48	*Application by Ergon Energy Corporation Limited (Labour Cost Escalators) (No 3)* [2010] ACompT 11 (24 December 2010)
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