



# REVIEW

Australian Energy Market Commission

## Perspectives on the building block approach

Review into the use of total factor productivity for  
the determination of prices and revenues

### Commissioners

Tamblyn  
Ryan  
Woodward

30 July 2009

## **Inquiries**

The Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

**E:** [aemc@aemc.gov.au](mailto:aemc@aemc.gov.au)  
**T:** (02) 8296 7800  
**F:** (02) 8296 7899

## **Citation**

AEMC 2009, *Review into the use of total factor productivity for the determination of prices and revenues, Perspectives on the building block approach*, 30 July 2009, Sydney

## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

This work is copyright. The Copyright Act 1968 permits fair dealing for study, research, news reporting, criticism and review. Selected passages, tables or diagrams may be reproduced for such purposes provided acknowledgement of the source is included.

# Contents

Contents .....	iii
Abbreviations .....	iv
Summary .....	v
1    Introduction .....	1
1.1    Definition of the building block approach .....	1
1.2    Methodology and structure of this report .....	2
1.3    Overview of key findings of the report .....	3
2    Benefits of the building block approach.....	5
2.1    Major benefits of the building block approach .....	5
2.2    Incentives within the building block approach.....	5
3    Drawbacks and costs of the building block approach .....	7
3.1    Major drawbacks of the building block approach.....	7
3.2    Disincentives within the building block approach.....	8
3.3    Information asymmetry .....	8
3.4    Costs associated with conducting pricing reviews.....	9
4    Effects of recent reforms.....	11
5    Adversarial aspects and costs of reviews and appeals.....	13
5.1    Adversarial aspects of the building block approach.....	13
5.2    Costs associated with reviews and appeals .....	14
5.3    Likelihood and frequency of merits reviews and appeals over time ....	14
A    Questions from the AEMC .....	17
B    Participating organisations.....	19

## **Abbreviations**

ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
ESC	Essential Services Commission (Victoria)
GPAL	Gas Pipelines Access Law
MAR	Maximum Allowed Revenue
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	National Electricity Market
NER	National Electricity Rules
NGL	National Gas Law
NGR	National Gas Rules
TFP	Total Factor Productivity

## **Summary**

In submissions made to the Issues Paper regarding the Australian Energy Market Commission's (AEMC's) total factor productivity (TFP) Review, stakeholders suggested that the AEMC should understand and identify the deficiencies with the current building block arrangements before considering changes to the current framework. Stakeholders requested that the AEMC investigate the benefits and costs associated with the building block approach.

In response to these submissions, the AEMC decided to obtain views on the current application of the building block approach. The AEMC conducted a survey of stakeholders in the form of a questionnaire. The questionnaire was sent to 40 stakeholders. Eighteen responses were received.

Participating stakeholders consider that the main benefit of the building block approach is that it is a relatively straight-forward, stable, certain and understandable process which yields sufficient incentives for service providers to seek cost efficiencies. The major drawbacks of the building block approach appear to be that it fails to cater adequately for innovation, there is a risk that the regulator may set the level of efficient prices too low leading to insufficient returns and that the regulator is exposed to information asymmetry.

Stakeholders noted that the building block approach may be adversarial at times, but it was acknowledged that this depends upon the relationship between regulator and the service provider.

Stakeholders also reported, in general terms, on the nature and quantum of costs for preparing and participating in regulatory decisions, including reviews and appeals. Some respondents believed that the costs of regulatory compliance were broadly the same over time while others thought that costs were increasing over time. There was a view that the likelihood and frequency of appeals and merits reviews over time is likely to diminish as the regulatory regime matures.

Recent energy market reforms, for the most part, are regarded to have improved the application of the building block approach although respondents indicated that some areas of reform remain.

This page has been intentionally left blank

# 1 Introduction

The building block approach is the current methodology adopted in most jurisdictions for setting regulated revenues and prices for electricity and gas transmission and distribution service providers.<sup>1</sup> In submissions made to the Issues Paper regarding the Australian Energy Market Commission's (AEMC's) total factor productivity (TFP) Review, stakeholders suggested that the AEMC should understand and identify the deficiencies with the current building block arrangements before considering changes to the current framework.<sup>2</sup> Stakeholders requested that the AEMC investigate the benefits and costs associated with the building block approach.

In response to these submissions, the AEMC decided to obtain views on the current application of the building block approach. The AEMC conducted a survey of stakeholders in the form of a questionnaire. In these questionnaires, the AEMC enquired as to:

- the benefits and drawbacks of the building block approach; the adequacy of incentives or presence of disincentives;
- whether recent national reforms improved or detracted from the application of the building block approach;
- whether the building block approach was adversarial in nature; and
- evidence on the nature and quantum of costs incurred in participating in assessments of revenue proposals or access arrangements and conducting merits reviews and appeals of regulatory decisions.

This report compiles and describes the results of the survey process undertaken by the AEMC through the responses to the questionnaires received from stakeholders.

## 1.1 Definition of the building block approach

According to the National Electricity Rules (NER) and National Gas Rules (NGR), the building block approach involves the determination of forecasts of efficient costs to set revenue and/or prices using the following types of costs or 'building blocks' for each year of a regulatory period:<sup>3</sup>

- indexation of the regulatory asset base;
- return on capital;

---

<sup>1</sup> The Northern Territory applies a TFP approach using externally benchmarked expected efficiency improvements.

<sup>2</sup> This was the view held by the following stakeholders: EnergyAustralia, Australian Energy Regulator (AER), Jemena, Ergon, Envestra, ETSA-Citipower-Powercor, Energy Users Association (EUAA) and the Australian Pipeline Industry Association (APIA).

<sup>3</sup> The building block approach is specified in clause 6.4.3 and clause 6A.5.4 of the NER and rule 76 of the NGR. A regulatory period is referred to as a 'regulatory control period' in the NER and an 'access arrangement period' in the NGR.

- depreciation;
- estimated cost of corporate income tax;
- revenue increments or decrements resulting from the operation of an incentive mechanism; and
- forecast operating expenditure.

Once total regulated revenue for each year is determined, the regulator uses a CPI-X framework to set a revenue or price path for the service provider. This revenue or price path sets the rate at which revenue or prices can change over time in real terms. Incentive mechanisms may operate outside of this cap and so revenues may change more or less than the cap.

The objective of the building block approach is to estimate the total revenue that the service provider will require each year over the forthcoming regulatory period to provide its investors with a reasonable rate of return and to allow the service provider to meet efficiently incurred costs relevant to providing the regulated services.

The building block approach is the methodology commonly adopted by most Australian jurisdictions in setting prices and revenues. While the building block approach in its current form as expressed in the NER and NGR is relatively new, the fundamental aspects of the building block approach were applied under former regimes for some years.

## **1.2 Methodology and structure of this report**

To determine the benefits and costs of the building block approach, the AEMC decided to seek the views of stakeholders by conducting a survey. A questionnaire was sent to various stakeholders, including service providers, regulatory authorities, industry bodies and user groups across Australia.<sup>4</sup>

In this questionnaire, the AEMC asked a series of questions reflecting the concerns that were canvassed by stakeholders in submissions to the AEMC's Issues Paper. That is:

- what are the benefits and drawbacks associated with the building block approach;
- whether there are sufficient incentives with the building block approach or whether there are any disincentives;
- whether information asymmetry is a problem and ways of ameliorating this problem;
- whether recent reforms to the energy regulatory framework had improved or detracted from the application of the building block approach;

---

<sup>4</sup> See Attachment A for list of questions sent to stakeholders.

- what is nature and quantum of costs for preparing and participating in an assessment of a revenue proposal or access arrangement proposal and whether these costs have changed over time;
- what is the nature and quantum of costs for conducting merits reviews of regulatory decisions and appeals; and
- what is the frequency and likelihood of reviews and appeals of regulatory decisions under the building block approach and whether the frequency and likelihood of such reviews and appeals have changed with time.

The AEMC prepared three versions of the questionnaire for each of the following groups: regulatory authorities; service providers; and industry or user groups. The questions for each questionnaire were, for the most part, similar in content with the exception of the following:

- two additional questions to regulatory authorities relating to information asymmetry;
- an additional question to service providers as to whether their costs for participating in regulatory decisions have changed with time; and
- an additional question to regulatory authorities and service providers relating to the frequency and likelihood of reviews and appeals of regulatory decisions.

The AEMC sent these questionnaires to 40 stakeholders and it received eighteen responses.<sup>5</sup> The stakeholders that provided a response did so for all the questions in the questionnaire except where they decided that a question was not applicable to their circumstances. No user groups responded.

This report compiles the responses that the AEMC received to its questionnaire. Each chapter of the report is structured according to the questions contained in the questionnaire and summarises the views of stakeholders with respect to each question.

This report does not include any conclusions, analysis or views of the AEMC drawn from the information provided to it. This will be included in the AEMC's forthcoming draft report for the TFP Review.

### **1.3 Overview of key findings of the report**

From the information provided by participating stakeholders it appears that the main benefit of the building block approach is that it is considered to be a relatively straight-forward, stable, certain and understandable process which yields sufficient incentives for service providers to seek cost efficiencies. The major drawbacks of the building block approach appear to be that it fails to cater adequately for innovation, there is a risk that the regulator may set the level of efficient prices too low leading to insufficient returns and that the regulator is exposed to information asymmetry.

<sup>5</sup> See Attachment B for a list of participating organisations.

Stakeholders noted that the building block approach may be adversarial at times, but it was acknowledged that this depends upon the relationship between regulator and the service provider.

Stakeholders also reported, in general terms, on the nature and quantum of costs for preparing and participating in regulatory decisions, including reviews and appeals. Some respondents believed that the costs of regulatory compliance were broadly the same over time while others thought that costs were increasing over time. There was a view that the likelihood and frequency of appeals and merits reviews over time is likely to diminish as certainty increases and the regulatory regime matures.

Recent energy market reforms, for the most part, are regarded to have improved the application of the building block approach although respondents indicated that some areas of reform remain.

## **2 Benefits of the building block approach**

### **2.1 Major benefits of the building block approach**

The AEMC asked the following question to all stakeholders:

What are the benefits of the building block approach in setting revenue and prices for regulated services?

The majority of responses stated that the main benefit of the building block approach is that it is a relatively straight-forward, stable, and predictable process that is easily understood.

Furthermore, respondents noted a number of other benefits associated with the building block approach:

- comprehensive assessment of costs so that service providers are guaranteed that they would recover their costs;
- ex-ante framework provides certainty for service providers and can be readily aligned with a service provider's internal planning and investment decisions;
- the assessment of costs is tailored to the circumstances of individual service providers;
- the assessment of costs is in a propose-respond framework allowing the regulator to rigorously test costs submitted to it from a service provider;
- it has the ability to consider both current and future network development needs when determining a price path;
- service providers were able to meet the costs of regulatory and legal obligations;
- the building block approach has flexibility to cater for a range of incentive schemes;
- it provides clarity on the extent of regulatory discretion in the revenue determination process; and
- in electricity transmission, it was noted that the building block approach catered for the 'lumpy' nature of transmission investment.

### **2.2 Incentives within the building block approach**

The AEMC asked the following question to all stakeholders:

Are there sufficient incentives within the building block approach for service providers to recover their efficient costs?

The majority of responses to this question stated that there were sufficient incentives to enable service providers to recover their efficient costs.<sup>6</sup> Respondents also stated that the service provider always has an incentive to recover the maximum amount of revenue. That is, there is an incentive for it to outperform the efficient and prudent costs set as part of a revenue or pricing determination and earn greater revenue.

The standard building block approach has the capacity to work with other regulatory mechanisms such as incentive schemes. Such mechanisms can be viewed as 'addons' to the standard building block approach to form a total regulatory package applied to a service provider. Respondents favourably regarded the ability of the building block approach to operate with these regulatory mechanisms. Respondents noted that these incentive schemes, including efficiency carryover mechanisms, could strike the appropriate balance between the various types of incentives. One regulator remarked that the current application of the building block approach adopts a middle ground in terms of incentives; that is, there is some incentive to keep expenditure at a minimum while also providing incentives to preserve service quality. Respondents cited the efficiency benefit sharing scheme (EBSS) and the service target performance incentive scheme (STPIS) as examples of incentive schemes that were effective in balancing different regulatory objectives.

In regard to the electricity sector, service providers commented on the reforms made to Chapter 6A of the NER (such as the propose-respond model, limitations on regulatory discretion, clear stipulation in the NER on how the AER will assess a revenue proposal). Service providers commented that these features contain beneficial incentives. Accordingly, the reforms should be allowed to continue operating as they were only introduced in 2006 and their use is still in its early stages.

---

<sup>6</sup> Only one respondent took the view that the building block approach does not have appropriate incentives.

### **3 Drawbacks and costs of the building block approach**

#### **3.1 Major drawbacks of the building block approach**

The AEMC asked the following question to all stakeholders:

What are the drawbacks with the current building block approach in setting revenue and prices for regulated services?

From the perspective of service providers, the major drawback of the building block approach cited was the difficulty for the regulator to determine a particular service provider's efficient costs. The problem of setting efficient costs led one service provider to argue that it was only possible to set efficient costs within a range, rather than obtain any particular or specific figures.

Service providers were concerned that a regulator may set the level of efficient prices too low, leading to insufficient returns. Setting prices too low would inhibit commercial innovation and act as a disincentive for investment or lead to under-investment.

Furthermore, service providers noted a number of other drawbacks associated with the building block approach:

- the process was very information or data intensive and that regulators sometimes issued onerous requests for information.<sup>7</sup> It was claimed that the information intensiveness could lead to a situation where service providers were effectively 'micro-managed' by a regulator;
- there was a perception that the process has become more heavy-handed over time. It was suggested that more recent reviews have been conducted in a more detailed, forensic and intrusive manner that is counter to the tenor of light-handed regulation;
- the lengthy duration of reviews;
- a perception that there are significant costs incurred in the regulatory process; and
- a concern that any cost efficiencies that service providers have achieved were subsequently lost when prices were reset to efficient costs at the beginning of each regulatory period.

---

<sup>7</sup> Although, it was expected that an alternative methodology would also be information intensive.

### **3.2 Disincentives within the building block approach**

The AEMC asked the following question to all stakeholders:

Are there any significant disincentives with the building block approach?

A number of responses identified that there were disincentives within the building block approach. The most significant disincentive identified by respondents was that the building block approach failed to provide for innovation or dynamic efficiency. These comments were raised in light of emerging regulatory challenges, such as the impact of climate change and introduction of new technologies. It was suggested that the building block approach simply allowed for a ‘business as usual’ approach because it does not require or encourage service providers to compete or deliver better or new services. It was suggested that service providers were not incentivised to invest or provide better services beyond the level endorsed by the regulator.

Some service providers also expressed concern that the right balance was not struck between the various incentives that are features of the broader building block approach package. For example, one respondent claimed that disincentives exist in relation to expenditure that does not contribute to the asset base. Even with an operating expenditure efficiency carryover mechanism, it was claimed that operating expenditure incentives, such as service performance improvements and non-network solutions, could be relatively disadvantaged compared to capital expenditure incentives.

Another respondent stated that there was an imbalance between capital and operating expenditure incentives. However, in contrast to the comments noted above, this respondent suggested that there should be efficiency carryover mechanisms for capital expenditure in the same way as operating expenditure.

### **3.3 Information asymmetry**

The AEMC addressed the following question specifically to regulatory authorities:

What difficulties or problems do you face in acquiring information on firm specific costs when applying the building block approach with respect to revenue, prices or access arrangement determinations?

From the perspective of most regulators, it was noted that the main deficiency with the building block approach was information asymmetry. That is, the relative lack of relevant information and knowledge held by the regulator about the service provider which makes it difficult for regulators to ascertain whether the costs presented by service providers represented efficiently incurred costs. In particular, a concern was expressed that regulators could be presented with ambit claims that presented exaggerated forecasts of future costs. One regulator stated that the data provided by a service provider was so unreliable that it was difficult to conduct an independent audit of the data.

The AEMC addressed a related question specifically to regulatory authorities:

Are there effective ways of ameliorating the difficulties in acquiring information on firm specific costs under the building block approach?

Regulators suggested that the information asymmetry difficulties they face could be addressed or ameliorated by clear legislative and regulatory obligations. This could include a robust audit framework to provide assurance over reported costs. One regulator suggested that consultation prior to the lodgement of regulatory information could assist in obtaining higher quality information. Another suggestion from regulators was to have clear cost allocation guidelines, although it was noted that such guidelines could be easily gamed by service providers.

In attempting to address the information asymmetry problems, one regulator commented that there was a balance that needed to be struck between revealing too much information that could stifle innovation on the part of the service provider and revealing too little information that could entrench the monopoly power of such a service provider.

### **3.4 Costs associated with conducting pricing reviews**

The AEMC asked the following question to all stakeholders:

What is the nature and quantum of the costs (in dollar figures and as a percentage of total regulated revenue) that you incur in preparing and participating in an assessment of a revenue/regulatory proposal or access arrangement proposal? Please comment on direct costs (for example, staff, use of external experts and legal advice) and indirect costs (such as corporate overheads).

Respondents indicated that the nature of costs involved in regulatory assessments of revenue and prices are:

- direct costs of legal fees, consultancy costs, internal staff and contractors; and
- indirect costs including corporate overheads, management time, opportunity costs for staff.

In general, service providers stated that the direct costs incurred ranged from \$2 million to \$5 million for an individual regulatory assessment. One service provider suggested that the entire process, inclusive of internal or indirect costs and hiring external experts (such as legal advisers), could amount to as much as \$15.7 million in absolute dollar amounts (however, this only amounted to 0.01% of total regulated revenue). Overall, the figures provided to the AEMC indicate that the cost to a service provider for preparing and participating in a regulatory process have generally accounted for 0.01% to 0.3% of total revenue over a five year regulatory period.

For regulators the direct costs of a revenue or pricing assessment process ranged from over \$0.5 million to \$3 million. One regulator noted that both its internal and external costs, including costs incurred for reviews, could amount to as much as

\$5 million to \$6 million for an industry-wide (that is, multiple service providers) electricity distribution review; and \$9 million for an industry-wide review of gas access arrangements.

The point was made by one regulator, however, that the quantum of costs is not directly associated with the size of the service provider's revenue and therefore it was not appropriate to express costs as a percentage of regulated revenue.

The AEMC addressed the following related question specifically to service providers:

Have these costs changed over time?

Some service providers said that these costs are expected to be or have been broadly consistent over time. Other service providers argued that the costs of regulatory compliance were increasing. Service providers submitted that the factors that led to increasing costs included:

- extensive industry and expert submissions needed to support regulatory proposals;
- detailed scrutiny of a service provider's business operations;
- turn-over of regulatory staff at the regulatory authority; and
- for electricity, introduction of reforms to Chapter 6A of the NER, which introduces greater rigour to the regulatory regime applicable to service providers.

One service provider noted that the increase in costs it faced in participating in a regulatory assessment is justified because the provision of information to support a regulatory proposal improved its ability to participate in the regulatory decision-making process. Another service provider expressed a similar view stating that while regulatory costs were increasing over time, these costs were prudent and necessary to ensure a fully compliant and substantiated regulatory proposal.

## 4 Effects of recent reforms

The AEMC asked the following question to all stakeholders:

Are there any recent national reforms (for example, changes to the NER or MCE reforms) that have improved or detracted from the application of the building block approach?

The responses received to this question were mostly supportive of the reforms. Stakeholders consider recent reforms have enhanced the rigour, transparency, certainty and accountability of the building block approach and may even reduce costs of regulation in the future.

In relation to electricity, service providers approved of the reforms to Chapter 6 and Chapter 6A of the NER. The reforms mentioned included: setting clear objectives and pricing principles, detailed and explicit decision-making process, limitations on the AER's discretion, information disclosure by transmission network service providers and the introduction of limited merits review.

In relation to gas, service providers were positive about the inclusion of objectives and pricing principles, clearer definition of the regulator's discretion and strengthening the coverage criteria for pipelines. The option for light regulation for pipelines where it was justified was also welcomed. It was noted that the National Gas Law (NGL) is a new regulatory regime, replacing the previous Gas Pipelines Access Law (GPAL) and the Code in July 2008. As such, the exact operation of the current regulatory regime is still in its formative stages. Nonetheless, one service provider's view was that the shift to a national regulatory regime should standardise the regulatory review process and reduce the costs of conducting reviews.

However, service providers also expressed some concerns about either the absence of reforms on certain matters or some negative consequences of recent reforms. Some electricity service providers were concerned about the lack of merits review available for the AER's cost of capital parameters (that is, the weighted average cost of capital (WACC)) decisions. This comment was made in the context where the AER's decisions regarding the WACC made under the NER are not specifically reviewable.<sup>8</sup>

Some gas service providers were concerned about the limited review rights under the NGL and NGR as the avenues to apply for merits review are now more limited than what was available under the GPAL. Gas services providers also identified the NGL and NGR as providing the AER with wider investigative and information gathering powers than were available under the previous regime. Some service providers stressed that the AER should only use these powers when necessary, and not as a matter of course; otherwise it may lead to intrusive regulation.

---

<sup>8</sup> However, it should be noted that the particular application of the WACC in a regulatory review process to individual service providers is subject to merits review.

One regulator stated that the introduction of merits review to the National Electricity Law (NEL) and NER made the regulatory review process more costly, adversarial and compounded the problem of information asymmetry. Further, the regulator suggested that the introduction of legislatively prescribed timelines into the regulatory review process combined with the practice of receiving late information from service providers, increased administrative costs for the regulator and made it more difficult for it to fully consider information in the decision making process.

Another regulator expressed concern about the risk of what it perceived as the 'mechanical' application of the AER service incentive scheme arrangements which would render it susceptible to gaming. Another regulator commented that under the new regimes there has been a greater prescription of economic concepts in legal instruments. In its view, this may not necessarily be in the long term interests of consumers.

## **5 Adversarial aspects and costs of reviews and appeals**

### **5.1 Adversarial aspects of the building block approach**

The AEMC asked the following question to all stakeholders:

To what extent do you consider that the determination process for revenue, prices or access arrangements to be adversarial in nature?

A number of respondents stated that the decision making processes under the NER and NGR were not intrinsically adversarial; rather it was natural for there to be a range of competing views. It was suggested that whether the process was adversarial in character depended upon the nature of the relationship that existed between the regulator and the service provider. For example, one regulator stated that if the service provider was government-owned then the determination process was less likely to be adversarial than if the service provider was a privately owned entity.

However, other respondents stated that the building block approach was demonstrably adversarial and forensic in nature. Some respondents stated that this was the natural outcome where there were issues of information asymmetry, limited time, changing rules and the presence of a dominant supplier. It was suggested that this tension was enhanced because reviews are conducted in a relatively formal or less open manner.

In regard to electricity reviews, one regulator noted that the introduction of a propose-respond framework supported by merits review was naturally adversarial. This regulator stated that this process implicitly assumes that the regulator will receive information from both the service provider and its users. Users, particularly consumers, are generally not able to provide information which is as extensive as that submitted by service providers. As a result, this leaves the regulator with the need to independently test the information provided by the service provider (rather than being able to rely on submissions by users and consumers). This may lead to the perception that the regulator was on the side of users and consumers rather than being an independent arbiter.

Other respondents took the view that the introduction of a propose-respond model and other changes to Chapter 6A of the NER improved the quality of information and thus reduced the likelihood of disputes.

A couple of service providers noted that a change to an alternative revenue and pricing methodology would not necessarily result in the regulatory process being less adversarial.

## **5.2 Costs associated with reviews and appeals**

The AEMC asked the following question to all stakeholders:

Since 1998, what is the nature and quantum of costs (in dollar figures and as a percentage of total regulated revenue) that has been incurred with respect to reviews (merits and judicial) and appeals of regulatory decisions (distribution and transmission revenue or access arrangement decisions) made using the building block approach? Please comment on costs such as staff, legal and expert advice, corporate overheads and preparation of documents.

Respondents identified the main costs involved as external costs relating to consultants, including lawyers. Internal staffing costs incurred by parties to a matter included the identification and preparation of documents.

In general, respondents (both regulators and service providers) indicated that a particular merits review or appeal can cost \$1 million to \$2 million in direct costs. However, it was noted that some merits reviews cost significantly less.

## **5.3 Likelihood and frequency of merits reviews and appeals over time**

The AEMC inquired on the following question addressed to regulatory authorities and service providers only:

What do you consider is the frequency and likelihood of reviews and appeals of regulatory decisions under the building block approach? Has the frequency and likelihood of such reviews and appeals changed with time?

Some service providers stated that the likelihood and frequency of merits review and appeals depended upon the extent that the regulator made decisions that were consistent with the relevant rules. However, there appeared to be a general view that it was likely that disputes over regulatory decisions would decrease over time as the current regulatory framework matures and certainty about its operation increases.

In the gas context for example, one service provider noted that the transition to a national regulator should see fewer reviews and appeals. In general, one respondent noted that the merits review process imposes a discipline on service providers to make sure that they reveal all relevant information to regulators as part of the regulatory process. Similarly, it was acknowledged that the option for review was an incentive for the regulator to make impartial, evidence-based decisions.

One regulator's view, however, was that the introduction of merits review lengthened the regulatory process and increased regulatory costs. Another regulator considered that the likelihood and frequency of disputes would increase over time under the current building block approach. It noted that reviews have extended beyond regulatory decisions to legal proceedings over the regulatory regime and the regulatory instruments themselves. It was claimed by the same regulator that 'the motivation [to commence a review] has been to cause delay and has not necessarily equated with any probability of success by the litigants'.

To obtain a sense of the frequency of disputes, the AER noted that the Australian Competition and Consumer Commission (under GPAL) made 19 decisions for gas transmission pipelines since the inception of that regime. Only four of these decisions were reviewed by the Australian Competition Tribunal. No appeals have been sought since 2003. For electricity, with the commencement of merits review in 2008, of the four transmission determinations and four distribution determinations made by the AER, six of these determinations were, or are continuing to be, subject to review by the Australian Competition Tribunal.

This page has been intentionally left blank

## A Questions from the AEMC

The questions sent to stakeholders (regulatory authorities, service providers and industry and user groups) are set out below. The questions for each questionnaire were, for the most part, similar in content with the exception of the following:

- two additional questions to regulatory authorities relating to information asymmetry;
- an additional question to service providers as to whether their costs for participating in regulatory decisions have changed with time; and
- an additional question to regulatory authorities and service providers relating to the frequency and likelihood of reviews and appeals of regulatory decisions.

The questions asked are set out below.

- Are there sufficient incentives within the building block approach for service providers to recover their efficient costs? Are there any significant disincentives with the building block approach?
- What are the benefits of the building block approach in setting revenue and prices for regulated services? What are the drawbacks with the current building block approach in setting revenue and prices for regulated services?
- What difficulties or problems do you face in acquiring information on firm specific costs when applying the building block approach with respect to revenue, prices or access arrangement determinations? [For regulatory authorities only]
- Are there effective ways of ameliorating the difficulties in acquiring information on firm specific costs under the building block approach? [For regulatory authorities only]
- What is the nature and quantum of the costs (in dollar figures and as a percentage of total regulated revenue) that you incur in preparing and participating in an assessment of a revenue/regulatory proposal or access arrangement proposal? Please comment on direct costs (for example, staff, use of external experts and legal advice) and indirect costs (such as corporate overheads).
- Have these costs changed over time? [For service providers only]
- Are there any recent national reforms (for example, changes to the National Electricity Rules or MCE reforms) that have improved or detracted from the application of the building block approach?
- To what extent do you consider that the determination process for revenue, prices or access arrangements to be adversarial in nature?

- Since 1998, what is the nature and quantum of costs (in dollar figures and as a percentage of total regulated revenue) that has been incurred with respect to reviews (merits and judicial) and appeals of regulatory decisions (distribution and transmission revenue or access arrangement decisions) made using the building block approach? Please comment on costs such as staff, legal and expert advice, corporate overheads and preparation of documents.
- What do you consider is the frequency and likelihood of reviews and appeals of regulatory decisions under the building block approach? Has the frequency and likelihood of such reviews and appeals changed with time? [For regulatory authorities and service providers only]

## B Participating organisations

The AEMC would like to thank the following organisations for their assistance in responding to its questionnaire:

User and industry groups:

- Australian Pipeline Industry Association
- Energy Networks Association
- Grid Australia

Service providers:

- ActewAGL
- Dampier Bunbury Natural Gas Pipeline
- EnergyAustralia
- Envestra
- Integral Energy
- Jemena
- Powercor-CitiPower
- SP AusNet

Regulatory authorities:

- Australian Energy Regulator
- Economic Regulation Authority (WA)
- Essential Services Commission of South Australia
- Essential Services Commission, Victoria
- Independent Competition and Regulatory Commission (ACT)
- Northern Territory Utilities Commission
- Office of the Tasmanian Economic Regulator