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16 April 2012

Richard Khoe  
Project Director  
Australian Energy Market Commission

By electronic lodgement

**Rule Change Requests Relating to Economic Regulation of Network Service Providers – Directions Paper ERC0134**

Dear Richard

Thank you to the Commission for providing Jemena with the opportunity to respond to your directions paper of 2 March 2012.

Please find our submission attached.

Please do not hesitate to contact me if you have any questions or require any clarification of our submission on 02 9455 1512 or [sandra.gamble@jemena.com.au](mailto:sandra.gamble@jemena.com.au).

Yours sincerely

A handwritten signature in black ink that reads "Sandra Gamble".

Sandra Gamble  
General Manager Regulation and Strategy



# **Rule Change Requests Relating to Economic Regulation of Network Service Providers – Directions Paper ERC0134**

**Submission from  
Jemena Limited  
to the  
Australian Energy Market Commission**

16 April 2012



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# Table of contents

<b>1</b>	<b>Executive summary.....</b>	<b>4</b>
<b>2</b>	<b>Introduction.....</b>	<b>5</b>
2.1	Context of this consultation.....	5
2.2	Jemena's network businesses.....	5
2.3	Structure of Jemena's submission.....	7
<b>3</b>	<b>The capital and operating expenditure framework in electricity.....</b>	<b>8</b>
3.1	The Commission's initial views.....	8
3.1.1	<i>Incentive to provide accurate forecasts, innovate and improve outcomes.....</i>	<i>8</i>
3.1.2	<i>What is driving electricity prices.....</i>	<i>9</i>
3.1.3	<i>Three process-related capex and opex factors.....</i>	<i>9</i>
3.2	Jemena's response to the Commission's initial view.....	9
3.2.1	<i>The policy framework.....</i>	<i>9</i>
3.2.2	<i>Incentive to provide accurate forecasts, innovate and improve outcomes.....</i>	<i>10</i>
3.2.3	<i>What is driving electricity prices.....</i>	<i>10</i>
3.2.4	<i>Three process-related capex and opex factors.....</i>	<i>12</i>
3.3	Jemena's answers to the Commission's questions 1 to 6.....	12
<b>4</b>	<b>Capital expenditure incentives in electricity.....</b>	<b>15</b>
4.1	The Commission's initial views.....	15
4.1.1	<i>Current capex incentives.....</i>	<i>15</i>
4.1.2	<i>Options for a new capex incentive scheme.....</i>	<i>16</i>
4.1.3	<i>Forecast capex allowance and actual capex.....</i>	<i>16</i>
4.1.4	<i>Actual or forecast depreciation.....</i>	<i>16</i>
4.1.5	<i>Uncertainty regime.....</i>	<i>17</i>
4.1.6	<i>Related party margins and capitalisation policy.....</i>	<i>17</i>
4.1.7	<i>Other incentive schemes.....</i>	<i>17</i>
4.1.8	<i>Shared assets.....</i>	<i>18</i>
4.2	Jemena's response to the Commission's initial view.....	18
4.2.1	<i>Current capex incentives.....</i>	<i>18</i>

4.2.2	<i>Options for a new capex incentive scheme</i> .....	18
4.2.3	<i>Forecast capex allowance and actual capex</i> .....	19
4.2.4	<i>Actual or forecast depreciation</i> .....	22
4.2.5	<i>Uncertainty regime</i> .....	24
4.2.6	<i>Related party margins and capitalisation policy</i> .....	24
4.2.7	<i>Other incentive schemes</i> .....	25
4.2.8	<i>Shared assets</i> .....	26
4.3	Jemena's answers to the Commission's questions 7 to 19 .....	28
<b>5</b>	<b>Rate of return frameworks for both electricity and gas</b> .....	<b>33</b>
5.1	The Commission's initial views .....	33
5.1.1	<i>Single national framework</i> .....	33
5.1.2	<i>Adapting to changing circumstances</i> .....	33
5.1.3	<i>Merits review</i> .....	34
5.1.4	<i>Benchmark efficient firm</i> .....	34
5.1.5	<i>Level of prescription</i> .....	34
5.1.6	<i>Ranges for parameter values</i> .....	35
5.2	Jemena's response to the Commission's initial view .....	35
5.2.1	<i>Single national framework</i> .....	35
5.2.2	<i>Adapting to changing circumstances</i> .....	35
5.2.3	<i>Merits review</i> .....	36
5.2.4	<i>Benchmark efficient firm</i> .....	36
5.2.5	<i>Level of prescription</i> .....	37
5.2.6	<i>Ranges for parameter values</i> .....	37
5.3	Jemena's answers to the Commission's questions 20 to 29 .....	38
<b>6</b>	<b>Cost of debt for both electricity and gas</b> .....	<b>41</b>
6.1	The Commission's initial views .....	41
6.1.1	<i>Current approach is problematic</i> .....	41
6.1.2	<i>Specification of the benchmark</i> .....	42
6.1.3	<i>Level of prescription</i> .....	42
6.1.4	<i>Trailing average approach</i> .....	42
6.2	Jemena's response to the Commission's initial view .....	43
6.2.1	<i>Current approach is problematic</i> .....	43
6.2.2	<i>Specification of the benchmark</i> .....	43

6.2.3	<i>Level of prescription</i> .....	43
6.2.4	<i>Trailing average approach</i> .....	43
6.3	Jemena's answers to the Commission's questions 30 to 34 .....	44
<b>7</b>	<b>The regulatory process for electricity</b> .....	<b>47</b>
7.1	The Commission's initial views .....	47
7.1.1	<i>Objective of the regulatory process</i> .....	47
7.1.2	<i>Three process-related capex and opex factors</i> .....	48
7.1.3	<i>NSP submissions during the regulatory process</i> .....	48
7.1.4	<i>Confidential information</i> .....	48
7.1.5	<i>Framework and approach paper</i> .....	49
7.1.6	<i>Material errors in regulatory determinations</i> .....	49
7.1.7	<i>Timeframes for cost pass through, contingent projects and capex reopener applications</i> .....	50
7.2	Jemena's response to the Commission's initial view.....	50
7.2.1	<i>Objective of the regulatory process</i> .....	50
7.2.2	<i>Three process-related capex and opex factors</i> .....	52
7.2.3	<i>NSP submissions during the regulatory process</i> .....	52
7.2.4	<i>Confidential information</i> .....	55
7.2.5	<i>Framework and approach paper</i> .....	56
7.2.6	<i>Material errors in regulatory determinations</i> .....	57
7.2.7	<i>Timeframes for cost pass through, contingent projects and capex reopener applications</i> .....	58
7.3	Jemena's answers to the Commission's questions 35 to 40 .....	59

# 1 Executive summary

Jemena supports many of the Commission's initial views set out in its directions paper, most of which identify areas in which the Commission requires additional evidence or analysis to enable it to develop a deeper understanding of:

- what is driving electricity prices and whether those drivers include any deficiency in the National Electricity Rules
- what influences actual capital expenditure and the options for creating the best incentives for the most efficient expenditure
- the desirability and nature of a single national framework for the Australian Energy Regulator to decide the cost of capital, particularly the cost of debt
- the best way to amend the regulatory process to ensure it enhances the Australian Energy Regulator's ability to produce decisions in which network service providers and all stakeholders have confidence.

In this submission, and through the Energy Networks Association, Jemena seeks to assist the Commission as much as possible with its evidence, insights and suggestions. Like many stakeholders, Jemena continues to support enhancements to the debt risk premium rules; to capital expenditure incentives; and to the rules that define the regulatory process. We also support initiatives beyond the rules to increase stakeholders' confidence in rules outcomes: better resourcing of consumer groups and better interaction between the Australian Energy Regulator, network service providers and stakeholders.

In the interests of the stability of the rules and the investment certainty they create, Jemena continues to encourage the Commission to apply a very high threshold before adopting changes to the rules—that threshold being whether the Commission itself is satisfied in each case there is a major problem that impedes the rules' ability to promote the national electricity or gas objective.

The diversity and complexity of the issues raised by the Australian Energy Regulator in its rule change proposal certainly creates challenges for the Commission to gain the required depth of understanding of the real problems and the best solutions, to test that understanding, and to develop draft rule changes by July 2012. As we prepared this submission, we became increasingly conscious of the magnitude of the Commission's challenge and offer to the Commission any assistance we can to achieve the best result.

## 2 Introduction

### 2.1 Context of this consultation

On 29 September 2011, the Australian Energy Regulator (**AER**) submitted two rule change requests (**AER rule change proposal**) to the Australian Energy Market Commission (**Commission**) in relation to the economic regulation of:

- electricity transmission and distribution network services providers (**NSPs**)
- covered pipeline service providers for gas transmission and distribution pipelines.

These requests were:

- National Electricity Amendment (Economic regulation of network service providers) Rule 2011, relating to the economic regulation of electricity transmission and distribution businesses, and
- National Gas Amendment (Price and revenue regulation of gas services) Rule 2011, relating to the determination of the rate of return for gas network businesses.

On 17 October 2011, the Commission received a rule change request from the Energy Users Rule Change Committee (**EURCC**) (representing a group of large energy users) relating to the calculation of return on debt for electricity network businesses under chapters 6 and 6A of the National Electricity Rules (**NER**).

Given that AER and EURCC have raised issues in the rate of return rules on the same subject matter, the Commission has decided the two rule change requests should be dealt with as a consolidated request.

The Commission issued its directions paper on 2 March 2012 (**Commission's directions paper**) in which it set out its initial views.

### 2.2 Jemena's network businesses

Jemena owns two network businesses. The AER's and the EURCC's proposed changes to chapter 6 of the NER and to part 9 of the National Gas Rules (**NGR**) would have a material effect on both of those businesses.

This submission sets out Jemena's response to those proposed changes and reflects our experience during our recent price reviews and merits reviews.



### *Jemena Electricity Networks (Vic) Limited*

Jemena Electricity Networks (Vic) Limited (**JEN**) is a distribution network service provider (**DNSP**) that serves 320,000 consumers in north western Melbourne.

The AER regulates JEN's revenues and prices under chapter 6 of the NER. On 29 October 2010, the AER released its final revenue determination<sup>1</sup> for JEN's current regulatory control period—1 January 2011 to 30 December 2015. JEN sought merits review of aspects of the AER's determination and the Australian Competition Tribunal (**Tribunal**) handed down its determination in respect of this review on 5 April 2012<sup>2</sup>.

### *Jemena Gas Networks (NSW) Limited*

Jemena Gas Networks (NSW) Limited (JGN) JGN is a covered pipeline service provider, within the meaning of the NGR, that serves 1,100,000 consumers in Sydney, Newcastle, Central Coast and Wollongong and over 20 regional centres across NSW.

The AER regulates JGN's access arrangement, which incorporates JGN's revenue, pricing and services, under parts 8, 9 and 10 of the NGR. On 11 June 2010, the AER released its final access arrangement determination<sup>3</sup> for JGN's current regulatory period—1 July 2010 to 30 June 2015. JGN sought merits review of aspects of the AER's determination and the Tribunal handed down its determination in respect of this review on 30 June 2011<sup>4</sup>.

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<sup>1</sup> AER, *Final, Jemena Electricity Networks (Victoria) Ltd, Distribution determination 2011–2015*, October 2010  
<http://www.aer.gov.au/content/item.phtml?itemId=740828&nodeId=f90d8ff7117d5b3d659e219b68f9a880&fn=Victorian%20distribution%20determination%20final%20decision%202011-2015%20-%20JEN%20final%20determination.pdf>.

<sup>2</sup> Application by United Energy Distribution Pty Limited [2012] ACompT 1 (6 January 2012) and Application by United Energy Distribution Pty Limited (No 2) [2012] ACompT 8 (5 April 2012).

<sup>3</sup> AER, *Final decision—Public Jemena Gas Networks Access arrangement proposal for the NSW gas networks, 1 July 2010 – 30 June 2015*, June 2010  
<http://www.aer.gov.au/content/item.phtml?itemId=737314&nodeId=1ad7842f5a6f6ca1c7ca1818abf1bc95&fn=Final%20decision%20-%20public.pdf>.

<sup>4</sup> Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6 (25 February 2011), Application by Jemena Gas Networks (NSW) Ltd (No 5) [2011] ACompT 10 (9 June 2011) and Australian Competition Tribunal, File No 5 of 2010, Determination, 30 June 2011.

## 2.3 Structure of Jemena's submission

Jemena's submission responds to the Commission's directions paper for both the AER's and the EURCC's rule change proposals. It follows the five broad subject areas identified in the Commission's consultation paper<sup>5</sup>:

- **Section 3** – The capital and operating expenditure framework in electricity
- **Section 4** – Capital expenditure incentives in electricity
- **Section 5** – Rate of return frameworks for both electricity and gas
- **Section 6** – Cost of debt for both electricity and gas
- **Section 7** – The regulatory process for electricity.

This submission is complementary to and should be read in conjunction with

- Jemena's submission on 8 December 2011 in response to the Commission's initial consultation on the AER's and EURCC's proposals
- the Energy Networks Association's (**ENA**) submission on the Commission's directions paper on 16 April 2012, which Jemena endorses.

In relation to each area of rule change, Jemena has set out the following:

- **The Commission's initial views**—Our understanding of the general direction the Commission has set for dealing with the proposals
- **Jemena response**—Our view on the Commission's initial views
- **Jemena's answers to the Commission's questions**—Jemena provides answers to the Commission's questions where we believe we can add specific insight based on our own experience and knowledge.

Wherever possible, we have provided quantitative analysis or data to support propositions and positions in our submission.

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<sup>5</sup> Australian Energy Market Commission, *Consultation paper: National Electricity Amendment (Economic regulation of network service providers) Rule 2011 and National Gas Amendment (Price and revenue regulation of gas services) Rule 2011*, 20 October 2011, p. 2.

## 3 The capital and operating expenditure framework in electricity

### Key points:

- Recent increases in electricity prices cannot be attributed to deficiencies in the NER or in their application by the AER.
- There are strong incentives for NSPs to submit forecasts that are “best in circumstances” and the AER has not been constrained in substituting its preferred forecast where it is not satisfied that an NSP’s forecast is reasonable.

### 3.1 The Commission’s initial views

#### 3.1.1 *Incentive to provide accurate forecasts, innovate and improve outcomes*


The NER should provide an incentive on NSPs to provide accurate forecasts (e.g. of demand) and to reveal efficient costs. It should provide incentives so that the most efficient NSPs earn the highest rewards and those that are inefficient are penalised.<sup>6</sup>

The NER should also encourage innovations which improve outcomes for consumers (e.g. lower costs or better service) through allowing businesses to keep a share of the benefits brought about by such innovations, while also shielding consumers from the risks of innovations which do not bring about such outcomes. Similarly, the risks from events which are beyond the direct control of NSPs should be appropriately shared between businesses and consumers. It should also provide stakeholders with certainty and transparency in respect of the regulator's decisions. Certainty and transparency create confidence in the regulator's decisions and allow investments to be appropriately planned.<sup>7</sup>

The Commission will undertake two streams of analysis to determine whether there is a problem with the capex and opex allowances framework and, if so, whether any changes to the NER are required. The first is to confirm that the policy intent

<sup>6</sup> Commission's directions paper. p. 14.

<sup>7</sup> Commission's directions paper. pp. 14-5.



established as part of the Chapter 6A rule determination is still an expression of good regulatory practice.<sup>8</sup>

If the Chapter 6A policy intent is appropriate then the Commission will review the NER to ensure that they give effect to that intent, including to avoid ambiguities on matters such as the use of benchmarking.<sup>9</sup>

### *3.1.2 What is driving electricity prices*

The Commission observes that there is in general a lack of evidence presented to support claims of a causal link between deficiencies in the NER and rising network costs.<sup>10</sup> The Commission considers that the level of analysis provided by stakeholders of the drivers for network cost increases to date has been limited and there may be scope for further analysis to inform the Commission's assessment.<sup>11</sup>

Accordingly, the Commission's second stream of analysis is to analyse any further evidence provided by stakeholders in response to this directions paper on the drivers of increases in network costs and the relationship between the framework for capex and opex allowances and increases in network charges.<sup>12</sup>

### *3.1.3 Three process-related capex and opex factors*

The Commission's initial view is that it would be appropriate to move the "procedural" factors in the way proposed by the AER and to clarify that the factors are not exhaustive. In terms of the reference to publication of analysis by the AER, the NER should be clarified to make it clear there is an obligation on the AER to publish its analysis with its draft or final regulatory determinations, but no obligation to do so prior to this.<sup>13</sup>

## **3.2 Jemena's response to the Commission's initial view**

### *3.2.1 The policy framework*

We note in section 3.1.1 above that the Commission proposes to review the policy intent established as part of the Chapter 6A rule determination to confirm that it is

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<sup>8</sup> Commission's directions paper. p. 28.


<sup>9</sup> Commission's directions paper. p. 28.

<sup>10</sup> Commission's directions paper. p. 25.

<sup>11</sup> Commission's directions paper. p. 21.

<sup>12</sup> Commission's directions paper. p. 28.

<sup>13</sup> Commission's directions paper. p. 33.



still an expression of good regulatory practice and then, if the policy intent is appropriate, review the NER to ensure that they give effect to that intent.

The ENA's submission includes a joint expert report from PricewaterhouseCoopers (**PwC**) and NERA Economic Consulting (**NERA**) which addresses those matters<sup>14</sup>. The report examines current regulatory practice in jurisdictions outside Australia and concludes that regulatory practice internationally indicates that the Commission's original policy intent remains appropriate. In particular, international practice continues to place an NSP's proposal at the centre of analysis. The report goes on to conclude that:

there is no evidence to support an argument for reducing the guided discretion to the AER on the grounds that the existing rules are failing to comply with the policy intent, or that the original policy intent is no longer relevant.<sup>15</sup>

Jemena endorses PwC and NERA's analysis and supports their conclusions.

### 3.2.2 *Incentive to provide accurate forecasts, innovate and improve outcomes*

Jemena's view is that the existing opex and capex objectives criteria and factors in chapter 6 of the NER, which guide the AER in evaluating and responding to NSPs' proposals, already provide incentives for accurate forecasts and schemes to improve efficiency in the interests of advancing the National Electricity (**NEO**) and the revenue and pricing principles.

These observations are borne out by Jemena's experience during the most recent distribution price review for JEN. We provided a detailed account of that experience in our submission on the Commission's consultation paper in December 2011.<sup>16</sup>

### 3.2.3 *What is driving electricity prices*


Jemena has contributed to and supports the ENA's submission on factors that have contributed to recent electricity price rises. Two NERA reports support the ENA's submission. .

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<sup>14</sup> PwC and NERA, *Capital and operating expenditure, Response to AEMC direction paper*, 16 April 2012, Attachment C of ENA, *Response to directions paper*, 16 April 2012.

<sup>15</sup> PwC and NERA, *Capital and operating expenditure – Response to AEMC direction paper*, 16 April 2012.

<sup>16</sup> Jemena's submission in response to the Commission's initial consultation paper, 8 December 2011, sections 4.2.2 and 4.2.3.



In the first, NERA has analysed the factors that have contributed to increases in network prices in the most recent round of price reviews which are the first conducted by the AER under the National Electricity Law (**NEL**) and the NER<sup>17</sup>. In the second NERA provide a critique of two reports prepared by Bruce Mountain<sup>18</sup> which the Energy Users Association Australia (**EUAA**) has submitted to the Commission in support of its position on the proposed rule changes<sup>19</sup>.

In their first report<sup>20</sup>, NERA concludes that observed price increases can be explained in large measure by observable and justifiable changes in costs—weighted average cost of capital (**WACC**), opex and capex—which have been reviewed and accepted by the AER, in many cases supported by advice received from its independent consultants. The AER has not been constrained in its ability to substitute its preferred forecasts in circumstances where it is not satisfied that an NSPs' proposal is reasonable and it is incorrect to attribute the increases to deficiencies in the regulatory framework or the NER in particular.

NERA's analysis shows that the equivalent weighted average  $P_0$  increase for the Victorian distribution NSPs at -9.7 per cent is the smallest of all jurisdictional increases. JEN's increase was -11.0 per cent.<sup>21</sup> In real terms, JEN's forecast opex for the 2011-15 period is less than actual opex over the 2006-10 period while forecast capex has increased by \$101 million to \$434 million. NERA describes the principal reasons for these changes in Table B.14. In each case the principal reasons are new or changed regulatory requirements.

In its second report<sup>22</sup>, NERA critiques the Mountain reports, which the Commission may consider, and casts serious doubt on the validity of Mountain's analysis and conclusions, especially that retail prices for electricity in Australia are high when compared to prices in other countries.

Jemena endorses NERA's analysis and supports its conclusions.

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<sup>17</sup> NERA, *Analysis of key drivers of network price changes*, 16 April 2012, Attachment A of ENA, *Response to directions paper*, 16 April 2012.

<sup>18</sup> Mountain, B.R., *Australia's rising electricity prices and declining productivity: the contribution of its electricity distributors*, May 2011 and Mountain, B.R., *Electricity Prices in Australia: an International Comparison*, CME, March 2012.

<sup>19</sup> NERA, *A review of two reports by Bruce Mountain for the Energy Users Association of Australia*, 16 April 2012, Attachment B of ENA, *Response to directions paper*, 16 April 2012.

<sup>20</sup> NERA, *Analysis of key drivers of network price changes*, April 2012.

<sup>21</sup> NERA, *Analysis of key drivers of network price changes*, April 2012, Table A.1.

<sup>22</sup> NERA, *A review of two reports by Bruce Mountain for the Energy Users Association of Australia*, 16 April 2012.

### 3.2.4 *Three process-related capex and opex factors*

Jemena has reservations about the Commission's initial positions in response to the AER's proposals to move "procedural" factors; to clarify that the factors are not exhaustive; and to clarify its obligations to publish its analysis and material that it has relied upon in reaching its decisions.

We respond to these points in detail in section 7.2.1 of this submission.

## 3.3 **Jemena's answers to the Commission's questions 1 to 6**

### *Question 1*

*Is the Commission's assessment approach, as set out in Chapter 2 and Appendix B, appropriate? Are there other factors that should be taken into account in assessing the rule change requests?*

Jemena has nothing to add to the Commission's assessment approach except that we question the Commission's definition of "useful life" for assets:

In this context the useful life of an asset is the point up to which it can safely continue to be used to deliver the outputs expected of the asset. In some cases the useful life of an asset may be beyond the regulatory depreciation period for the asset.<sup>23</sup>

In Jemena's view, the relevant test must be an economic one. Even where safe operation is the primary consideration, the decision to replace an asset is invariably made on economic grounds.

### *Question 2*

*The Commission seeks further evidence on the drivers for increases in network costs, and in particular on the link between capex and opex allowances under the NER and such increases in network costs.*

Jemena supports the ENA's response to this question and in particular the NERA report which informs that response. In summary, observed increases in network costs can be explained in large measure by observable changes in cost drivers which have been reviewed and accepted by the AER, in most cases supported by advice received from its consultants. It is incorrect to attribute the increases to deficiencies in the rules. The AER has not been constrained in its ability to substitute its preferred forecasts in circumstances where it is not satisfied that the NSP's proposal is reasonable.

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<sup>23</sup> Commission's directions paper, footnotes 9 and 590.

*Question 3 Would it be appropriate for the wording of the NER to be clarified to better reflect the policy intent?*

In section 3.2.1 we refer to the PwC/NERA joint expert report that forms part of the ENA's submission. That report, which we support, concludes that existing rules are consistent with the Commission's policy intent which is, in turn, consistent with current international regulatory practice.<sup>24</sup>

*Question 4*

*What circumstances of the NSP should the AER be required to take into account when benchmarking?*

Sections 6.5.6 and 6.5.7 of the NER define the operating expenditure objectives and capital expenditure objectives respectively. The two sets of objectives are identical and are all clearly "firm specific"—each refers to the standard control services that are provided by the relevant NSP. It follows that a benchmarking analysis cannot be valid unless it takes account of or "normalises" for differences between the environments in which the subject NSP and comparator businesses operate where those differences have a bearing on the level of expenditure required to achieve the objectives. Those differences include such things as customer density, customer mix and load factor, reliability and service standards, urban vs rural, topography and climate.

Jemena agrees that it would not be appropriate to consider the characteristics of the subject business such as the quality of management or its ownership structure. As far as Jemena is aware, no-one has suggested that such endogenous factors should be taken into account in applying benchmarking. Neither is there any evidence that the AER has been constrained in applying benchmarking techniques. In that regard, we note that engaging independent consultants as the AER does routinely is a form of benchmarking in that it brings the consultants' experience and knowledge of other businesses to bear on the matters under review. We note also that the Productivity Commission is presently conducting an inquiry into Electricity Network Regulation with a focus on the role of benchmarking in setting network prices.

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<sup>24</sup> PwC and NERA, *Capital and operating expenditure – Response to AEMC direction paper*, 16 April 2012.



### Question 5

*Would it be appropriate for the capex objectives to be clarified to better reflect jurisdictional reliability standards?*

Jemena acknowledges that the use of the word “maintain” in the opex and capex objectives<sup>25</sup> could be interpreted to mean that the quality, reliability and security of supply could never be reduced even if the relevant standards were relaxed. However we note that jurisdictional quality, reliability and security of supply standards will invariably be expressed as regulatory obligations and so standards as they are from time to time will be covered by the objectives in NER sections 6.5.6(2) and 6.5.7(2). If that is the case then those sections are potentially in conflict with sections 6.5.6(3) and 6.5.7(3), or the latter sections are redundant. It is possible that, in some circumstances, standards could be set otherwise than through a regulatory obligation in which case it would seem appropriate for sections 6.5.6(3) and 6.5.7(3) to refer to standards that are not expressed as regulatory obligations being maintained at applicable levels.

Jemena’s principal concern is that, prudently incurred capex that is required to meet standards applicable at a particular point in time should not be stranded if standards are subsequently relaxed. If assets were stranded then there would be a case for de-commissioning and/or re-deploying them where that is feasible.

### Question 6

*What factors or features of the approaches of other regulators should be taken into account when reviewing other regimes to confirm the best practice approach to economic regulation?*

In section 3.2.1 we refer to the PwC/NERA joint expert report that forms part of the ENA’s submission. The report examines current regulatory practice in New Zealand, the United Kingdom and the United States. In Jemena’s view that examination covers all the features of those regimes that are relevant to forming a view as to whether the capital and operating expenditure framework in the NER conforms to current best practice.<sup>26</sup>

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<sup>25</sup> NER, sections 6.5.6(3) and 6.5.7(3).

<sup>26</sup> PwC and NERA, *Capital and operating expenditure – Response to AEMC direction paper*, 16 April 2012.

## 4 Capital expenditure incentives in electricity

### Key points:

- The current regime does not provide NSPs with an incentive to spend more than the capex forecast approved by the AER, but there are undesirable incentives to defer capex within a regulatory period.
- It is inevitable that forecast and outturn expenditure will be different.
- There is an opportunity to improve the current incentives and a capex efficiency benefit sharing scheme (**EBSS**) that operates symmetrically and continuously is the means to do this.

### 4.1 The Commission's initial views

#### 4.1.1 *Current capex incentives*

The Commission is of the view that the capex incentives in the NER do not create an incentive for an NSP to spend more than its allowance in its regulatory determination.<sup>27</sup>

The current mechanism provides that an NSP will have to bear the costs of any overspend during a regulatory control period until the start of the next regulatory control period. The power of the incentive under the current arrangements declines throughout the regulatory control period. This has two key timing implications:<sup>28</sup>

- NSPs have a greater incentive to make efficiency gains at the start of the period
- an incentive is created for NSPs to defer capex from early in the period to late in the period.

As the power of the incentive for opex is constant, the declining power of the capex incentive is also likely to increase any incentive to replace opex with capex later in the regulatory control period.

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<sup>27</sup> Commission's directions paper. p. 40.

<sup>28</sup> Commission's directions paper. p. 43.

#### 4.1.2 *Options for a new capex incentive scheme*

The Commission is minded to focus on exploring other options other than that the AER proposed for dealing with the problems it raised.<sup>29</sup>

These options include:

- an efficiency benefits sharing scheme developed in the form of a guideline
- ex-post reviews of the prudence and efficiency of capex
- optimisation of the regulatory asset base (**RAB**) at regulatory resets.<sup>30</sup>

#### 4.1.3 *Forecast capex allowance and actual capex*

To assess these options, the Commission wishes to understand the circumstances in which an NSP would need to spend more [or less] than its allowance and the approaches taken in other overseas and Australian jurisdictions. Rather than prescribe an approach in detail, it would prefer to establish principles and enable the AER to develop the solution consistently with those principles.<sup>31</sup>

#### 4.1.4 *Actual or forecast depreciation*

In its directions paper, the Commission acknowledges that:

- under the actual depreciation approach, if an NSP underspends or overspends the expenditure allowance, the depreciation adjustment to the capital base will be recalculated to reflect the difference between actual and forecast capex
- a forecast depreciation approach has a neutral effect on the capex incentives because depreciation adjustment will be the same regardless of the actual expenditure outcome.<sup>32</sup>

The Commission will examine the relevant factors further to consider whether the AER should have discretion to use actual or forecast depreciation or whether a particular approach should be prescribed in the NER.<sup>33</sup>

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<sup>29</sup> Commission's directions paper. p. 43.

<sup>30</sup> Commission's directions paper. pp. 44-5.

<sup>31</sup> Commission's directions paper. pp. 45-6.

<sup>32</sup> Commission's directions paper. p. 48.

<sup>33</sup> Commission's directions paper. p. 50.

#### 4.1.5 *Uncertainty regime*

The need for proposed changes to the uncertainty regime [or in the case of DNSPs, the establishment of an uncertainty regime] may depend on whether other proposed changes are made as part of the rule change process. Despite this, the Commission has considered whether there is any other justification for the changes the AER proposed to the uncertainty regime.<sup>34</sup>

There appears to be merit in the AER's proposals in respect of the uncertainty regime, although the details of the way it would apply need to be considered further. It would also be appropriate to revisit the overall need for the changes once the response to the proposals on capex/opex allowances and capex incentives are developed further.<sup>35</sup>

#### 4.1.6 *Related party margins and capitalisation policy*

The Commission's initial view is that there is an issue in relation to changes in capitalisation policy by NSPs during a regulatory control period and that the solution proposed by the AER may be appropriate. However, if stronger capex incentives are applied, such as through an EBSS for capex, this may also address some or all of the problem.

The Commission would like to understand further the strength of the additional incentive for NSPs to not seek efficient outcomes in regard to related party margins than there is for other costs.<sup>36</sup>

#### 4.1.7 *Other incentive schemes*

The Commission's initial view is that the rule change process may be overly burdensome for introducing new incentive schemes, particularly where these schemes may need to be tested before their true value can be determined.

The Commission is also of the initial view that the NER should allow the AER to develop small scale pilots or test schemes within an environment that limits the sum of money at risk and the length of time of the scheme prior to the AER submitting a rule change.<sup>37</sup>

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<sup>34</sup> Commission's directions paper. p. 52.

<sup>35</sup> Commission's directions paper. p. 53.

<sup>36</sup> Commission's directions paper. p. 58.

<sup>37</sup> Commission's directions paper. p. 62.

#### 4.1.8 *Shared assets*

Using electricity assets for additional purposes should reduce the (average) costs of providing electricity services since the fixed costs are spread over a larger number of consumers. This promotes efficient use of electricity services with respect to price. This could be seen as a form of innovation, which NSPs should be encouraged to achieve, where it does not have a negative effect on the service provided to electricity consumers.<sup>38</sup>

The Commission now seeks input on the best form of a solution. The solution will include guiding principles, and may also involve changes to the NER to enable an appropriate mechanism.<sup>39</sup>

## 4.2 **Jemena's response to the Commission's initial view**

### 4.2.1 *Current capex incentives*

Jemena agrees with the Commission's observation that the NER do not provide NSPs with an incentive to spend more than the capex allowance though there may be incentives on NSPs to defer capex inefficiently. Jemena is also pleased that the Commission shares the concerns of stakeholders (including Jemena) regarding the AER's 60 per cent proposal.<sup>40</sup>

### 4.2.2 *Options for a new capex incentive scheme*

Jemena supports the development of a symmetrical capex EBSS that addresses the issues the Commission identifies. We agree with the Commission that the scheme should be specified in a guideline to be developed by the AER rather than in the NER itself. However, the guidance provided in section 6.5.8(c) of the NER as it relates to capex incentive schemes is presently too general. Jemena supports the ENA's conclusion that the NER should be amended to provide a more detailed and clearer specification of the guidance for the AER to develop a capex EBSS under the NER.

As to the specifics of that guidance, Jemena supports the criteria that are set out in section 3 of the joint expert report on capital and operating expenditure that forms part of the ENA's submission.<sup>41</sup>


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<sup>38</sup> Commission's directions paper. p. 64.

<sup>39</sup> Commission's directions paper. p. 65.

<sup>40</sup> Commission's directions paper. p. 34.

<sup>41</sup> PwC and NERA, *Capital and operating expenditure – Response to AEMC direction paper*, 16 April 2012.



Jemena is pleased that the Commission shares stakeholders' concerns about the AER's proposed asymmetric capex incentive mechanism and supports the Commission's conclusion that capex incentives should not be changed to address a cost of capital issue.<sup>42</sup>

In support of its proposal for an asymmetric capex incentive mechanism, the AER argues that businesses will have an incentive to overspend capex inefficiently where the regulatory WACC exceeds the business's actual cost of capital. A number of submissions, including Jemena's, point out that this incentive will exist only if the WACC "bias" can be expected to exist for the entire life of the asset(s). If there was such a bias, it would indicate a problem with the way in which the WACC is set. But the AER's proposal would address just one symptom of that problem—the postulated incentive to over-spend capex—and not its cause. In Jemena's view that is not appropriate: if a problem exists, it should be addressed directly.

What the AER's analysis does show<sup>43</sup> is that, in the absence of a WACC bias (and even where there is a bias), the dominant incentive under current arrangements is to defer capex within a regulatory period. Once again, a number of submissions support that observation and the Commission correctly identifies that as the principal issue requiring attention.

#### *4.2.3 Forecast capex allowance and actual capex*

The AER's proposal for an asymmetric capex incentive scheme is, in part, a response to observed differences between forecast capex allowances in past regulatory determinations and subsequent actual capex. In Jemena's view the use of the term "forecast capex allowance" to describe what is no more than a forecast conveys a false impression of precision. Differences between forecast and actual are inevitable and allowing the AER the wider discretion it seeks will not lead to better forecasts.


#### *Use of the term "forecast capex allowance" conveys a false impression of precision*

The term "forecast capex allowance" is used throughout the AER's rule change application and also routinely in regulatory discourse. However, we see the term as a second best descriptor because it suggests that the forecast is a cap on expenditure that should not be exceeded. The AER appears to rely on that view to justify its asymmetric capex incentive mechanism. In fact the "allowance" is no more than a forecast which is just one input to the building block calculation. The

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<sup>42</sup> Commission's directions paper, p. 40.

<sup>43</sup> AER Rule change proposal, section 6.4.2 and Figure 6.2.



heading to section 6.5.7 of the NER—Forecast Capital Expenditure—says as much.

The capex forecast covers a period that extends 6 or more years from when the forecast is made and is a function of many factors, some of which are within the control of the business and others which are not, and most of which have wide ranges of uncertainty. Conceptually and in practice, that is very different from an annual capital budget or project budget that may be set by a business, be it regulated or unregulated. Such budgets cover activities that have been confirmed and approved as necessary based on then-current information and for which a defined level of expenditure has been approved by the business's management or board. The capex forecast for a regulated business may reflect budgeted or confirmed projects in the near term, but beyond that it is simply a forecast of expected expenditure requirements based on engineering and other inputs and assumptions. Like all forecasts, it is more certain and precise in the near term than it is in the longer term.

Forecast capital expenditure must satisfy the capital expenditure criteria which includes that the forecast should reasonably reflect the efficient costs of achieving the capital expenditure objectives.<sup>44</sup> The AER has the difficult task of determining what the forecast should be. However, as we observed in our initial submission, the true level of efficient costs for a business cannot be known with any certainty: if it could be then there would be no need for incentive regulation.<sup>45</sup>

There are only two instances of the word “allowance” in Chapter 6, both in schedule S6.2.3(d) which deals with the treatment of working capital. By using the term “forecast capex allowance”, as it does throughout its application, the AER implies that the capex forecast it determines has a quality of absolute truth: the forecast is in fact the business's efficient costs, so, if the business operates efficiently, that “allowance” will only be exceeded in exceptional circumstances. At the same time the AER recognises that the “allowance” can be inaccurate by proposing that Chapter 6 be modified to include the contingent projects and capex re-opener arrangements currently available in transmission.


#### *Forecasting error is inevitable*

It is inevitable that there will be differences between any forecast and the actual outcome, particularly in the later years of the forecast period, and in many cases the explanation for the difference may simply be that the forecast was wrong or

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<sup>44</sup> NER, s. 6.5.7(c)(1).

<sup>45</sup> Jemena's submission in response to the Commission initial consultation paper, 8 December 2011, section 3.1.4.



unrealistic. Even if the forecast was reasonable and the best available at the time it was made, the only certainty is that the actual outcome will be different, and the differences are likely to be greater the longer the time horizon of the forecast. For example, a significant proportion of capex is driven by demand growth and new connections which are in turn a function of many factors including general economic conditions and government policies. Expenditure to meet demand growth and new connections is not discretionary. While other, discretionary, capex might be deferred to compensate for non-discretionary capex exceeding forecast, that deferral can only be temporary and may well be inefficient.

Referring to the capex forecast as an allowance and proposing an asymmetric capex incentive mechanism implicitly denies the inevitability of forecasting error.

*Wider discretion will not lead to better forecasts*

The AER's ability to forecast efficient costs will not be improved by giving the AER the additional discretion it seeks. The AER has indicated publicly that its objective would be to make an unbiased estimate of efficient costs.<sup>46</sup> It doesn't say whether that is an unbiased estimate of the mean or of some unstated percentile of the distribution of possible forecasts. Of course if it was the mean then, for a given business, there must be an equal probability that actual efficient costs will be greater than or less than the forecast. Given the range of uncertainty around such a forecast, that would not amount to providing the service provider with "a reasonable opportunity to recover at least the efficient costs the operator incurs ..."<sup>47</sup>

If the AER was given the discretion it seeks then its decisions would no doubt be different, and would probably result in lower network prices than under current rules if the AER's public statements are to be taken at face value.<sup>48</sup> However, the AER has not made the case that those decisions would amount to a better estimate of efficient costs, or better satisfy the revenue and pricing principles, than those it makes under existing rules. If the AER had greater discretion it would simply be less accountable for its decisions.

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<sup>46</sup> *ibid.*

<sup>47</sup> NEL, s. 7.

<sup>48</sup> Reeves, A., 2011, *Finding the balance—the rules, prices and network investment*, Energy Users Association of Australia Energy price and market update seminar, 20 June 2011, Melbourne. <<http://www.euaa.com.au/events/epmu/Presentations%202011/Reeves,%20Andrew.pdf>>



#### 4.2.4 *Actual or forecast depreciation*

Jemena welcomes the Commission's examination of the factors relevant to the choice of actual or forecast depreciation—they go beyond the effect of depreciation itself.

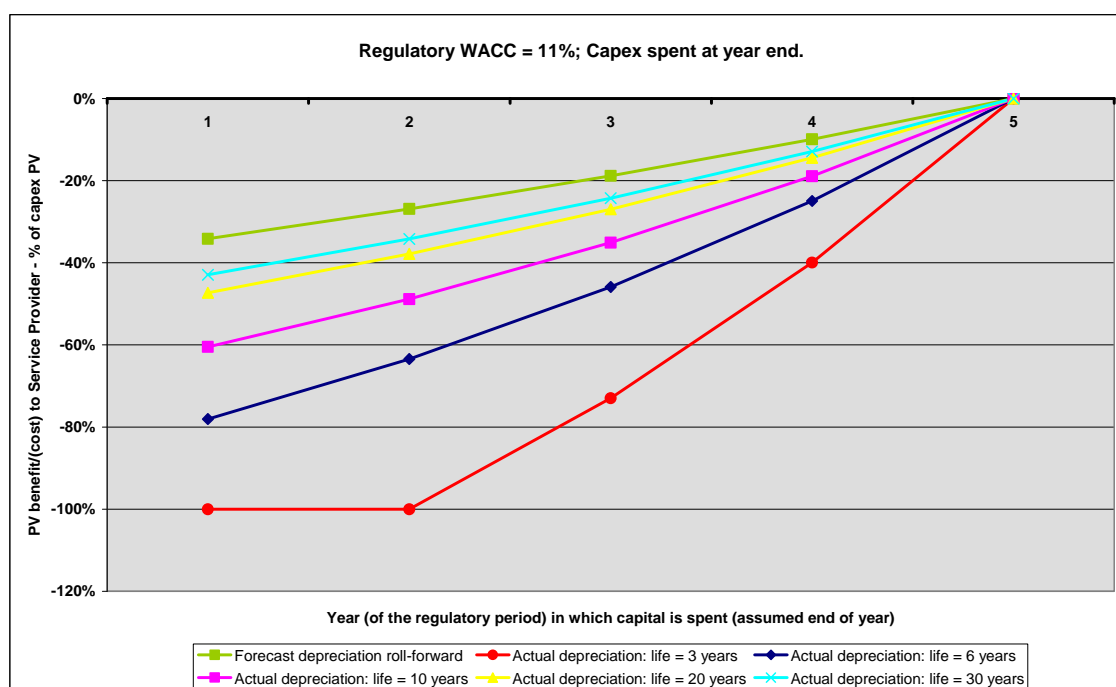
The Commission's directions paper describes and discusses the incentive to defer capex within a regulatory period in section 4.2 and the alternative approaches to depreciation in the RAB roll-forward calculation in section 4.3. The two are closely related and additive in their incentive effects.

An incentive to defer capex within a regulatory period is undesirable. Capex spent early in the regulatory period incurs a present value cost because the NSP does not begin to earn a return on and of that capex until the beginning of the next regulatory period when it is rolled into the RAB. In practice, NSPs have limited capacity to defer capex within a regulatory period. A significant proportion of capex is driven by factors, such as demand growth, that are outside the NSP's control and resourcing constraints limit the extent to which capex can be deferred within a regulatory period. NSPs are in effect penalised for making non-discretionary capex early in the regulatory period inasmuch as they are denied the opportunity to respond to the incentives to defer.

The distinction between the two alternatives for depreciation in the RAB roll-forward calculation—forecast depreciation and actual depreciation—is that forecast depreciation provides for financial capital maintenance whereas actual depreciation does not. That is, with forecast depreciation, the RAB at the beginning of the next regulatory period is increased by the full value of actual capital expenditure during the current period whereas when actual depreciation is used, the increase in the RAB at the beginning of the next period will be greater than/less than actual expenditure if actual expenditure is less than/greater than forecast.

Importantly, if there is no capex EBSS and actual depreciation is used, the two incentives combine so that the outcome for the NSP is a function of the depreciation life of the assets involved as well as the point in the regulatory period at which the expenditure occurs. Expenditure on short-lived assets early in the regulatory period is particularly severely penalised. Thus the overall outcome for the NSP is a function of actual expenditure at the asset class level rather than at the aggregate level. On the other hand, when forecast depreciation is used, the outcome is independent of asset life but remains a function of when in the regulatory period the expenditure is made. These relationships are illustrated in the following graph which plots present value benefit/(cost) to the NSP as a percentage of the present value of capex against the year in the regulatory period in which the expenditure occurs.


**Figure 4.1 – PV effect of incremental capex – RAB roll-forward bases compared**



There are two effects:

- The top “Forecast depreciation roll-forward” line shows the incentive to defer capex within the regulatory period. The incentive declines as the capex is deferred and is independent of asset life.
- The lower lines assume actual depreciation is used in the roll-forward calculation. In those cases there is an additional present value cost which increases as the asset life becomes shorter. To the extent that the incremental capex is depreciated during the current regulatory period, that value is not rolled into the RAB. Expenditure early in the period on assets that have very short lives will not be recovered at all.

These distorting incentives are clearly undesirable. A properly constructed capex EBSS that provides continuous and symmetrical incentives can address the current incentive to defer capex within the regulatory period. However, an EBSS would not address the unfavourable relationship between outcome and asset life if/when actual depreciation is used.



Jemena supports a change to the rules to give the AER guided discretion to choose between using forecast and actual depreciation in the roll-forward calculation but with a presumption in favour of using forecast depreciation if there is a capex EBSS.

#### 4.2.5 *Uncertainty regime*

In Jemena's submission in response to the Commission's consultation paper we expressed reservations about the suitability of the contingent projects regime for distribution NSPs and noted that a re-opener regime, which may accommodate specific high-cost projects, would not deal with an unexpected increase in program capex requirements such as that driven by increased demand and/or connection numbers.<sup>49</sup>

We would add that, if a capex EBSS is introduced, then non-discretionary capex that is prudently incurred as a result of events that are beyond the control of the NSP should be excluded from the operation of the EBSS. This requirement is discussed as Criterion 6 in the PwC/NERA joint expert report which forms part of the ENA's submission.<sup>50</sup>

#### 4.2.6 *Related party margins and capitalisation policy*

##### *Related party margins*

In Jemena's view the existence of related party margins has, at most, a second order influence on capex incentives and outcomes.


Incentives work on marginal expenditure and affect decisions to spend or save incremental capex. If an NSP contracts out the provision of capex services and pays a margin for those services then, assuming the level of margin to be the same in either case, the position of the NSP itself and that of consumers is the same irrespective of whether the outsourced provider is related or unrelated. Furthermore, and importantly, the NSP's shareholders will be required to provide the same amount of capital plus margin in either case.

Where the service provider is a related party of the NSP, there is a "group" perspective to be considered. The group will be better off to the extent that the margin paid on incremental capex exceeds the group's incremental costs. Any

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<sup>49</sup> Jemena's submission in response to the Commission's initial consultation paper, 8 December 2011, pp. 51–2.

<sup>50</sup> PwC and NERA, *Capital and operating expenditure – Response to AEMC Direction paper*, 16 April 2012.



such excess might be regarded as an offset to the incremental capital that the group must provide.

Margins are set by contract and, particularly if paid to a related party, are subject to ex-ante review by the AER. We have also indicated that ex-post review of new or changed margins may be appropriate.<sup>51</sup> In Jemena's view, the extent of any difference between incremental margin and incremental costs is unlikely to affect materially the group's inclination or incentives to provide capital where, as we have noted previously, private sector NSPs are subject to a variety of constraints on expenditure including, for example, maintaining the business's credit rating and complying with debt covenants. Businesses are generally capital-constrained, especially in today's climate.<sup>52</sup>

#### *Capitalisation policy*

The Commission observes that stronger capex incentives, through an EBSS for example, may deal with the issue [of changing capitalisation policy during a regulatory period] by removing the incentive to capitalise opex inefficiently.<sup>53</sup> Jemena agrees with this observation. A well-constructed capex EBSS can and should be calibrated so that, together with other incentive arrangements, there is a balanced incentive to optimise capex, opex and service performance.

#### *4.2.7 Other incentive schemes*

We concur with the Commission that the rule change process may be an overly burdensome means of introducing a potential new scheme if it must be tested and proven before it is implemented in full.


Giving the AER power to develop and pilot test new schemes is a sensible option. However, it should not be open to the AER to impose a test scheme on a business. Test schemes should be designed and developed in consultation with NSPs; testing should only be conducted with the agreement of the affected business(es); and the amount of revenue at risk should be small. If testing shows that a scheme has merit and should be considered for general application, then that should be done through a rule change.

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<sup>51</sup> Jemena's submission in response to the Commission's initial consultation paper, 8 December 2011, p. 55.

<sup>52</sup> Jemena's submission in response to the Commission's initial consultation paper, 8 December 2011, p. 44.

<sup>53</sup> Commission's directions paper, p. 57.



In the meantime, the AER should place priority on developing improved incentive schemes for capex and demand side participation projects for which the NER already allows.

#### *4.2.8 Shared assets*

The Commission's initial view is that there should be a flexible mechanism for establishing a revenue decrement for the sharing of standard control assets and there should be a set of principles to guide the AER in its decision making. Jemena supports this approach.

Additionally, Jemena welcomes the Commission's support for the view that the use of standard control assets for alternative control services should be excluded from the uses for which consumers should receive compensation.


#### *Appropriate guiding principles*

In Jemena's submission in response to the Commission's consultation paper on the AER's and EURCC's proposals, we proposed a set of guiding principles that should guide any decision by the AER on the amount of revenue to be shared with consumers. Any sharing arrangement must:

- apply only to revenues after netting off all relevant costs, including the risks associated with the use of standard control assets
- take into account the detrimental effect of any form of sharing on the incentives of DNSPs to develop such alternative sources of revenue
- be developed so as to minimise the associated regulatory burden
- be applied in such a way that new forms of unregulated service are granted a sharing holiday for, say, a minimum initial period – of perhaps 3 or 5 years
- provide a basis for deciding the amount of revenue to be shared with consumers
- disregard services that are unlikely to be material
- be designed so as to be proportionate to the amounts involved.<sup>54</sup>

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<sup>54</sup> Jemena's submission in response to the Commission initial consultation paper, 8 December 2011, p. 109.



We also proposed that the default approach to the sharing of (net) unregulated revenues from standard control assets should be by way of an annual revenue forecast, perhaps with an ex post true up which could be done in the following regulatory control period.

While the Commission has accepted the key principles from our submission, the Commission's initial position is:

While the extent of sharing should also take account of some of the risks involved to the NSP, the NSP cannot be insulated from all risks, and the requirement of sharing should not be subject to a positive commercial outcome having been achieved.<sup>55</sup>

Jemena accepts that the NSP cannot be insulated from all risks. However, there should be protections to ensure that the share of revenue that the AER determines should be passed through to consumers does not contribute to a negative commercial outcome for the DNSP. That is, the DNSP must not be subject to regulatory risk in addition to its commercial risks. Exposure to regulatory risk would detract from the incentives for DNSPs to actively seek new forms of unregulated services that utilise regulated assets.

#### *Exclusion of assets used for alternative control services*

Jemena supports the exclusion of assets for alternative control services from the uses for which consumers should receive compensation.

In the directions paper, the Commission notes that Ausgrid are of the view that alternative control services should be excluded from the uses of assets which would result in additional compensation to consumers. Ausgrid submitted:

There is also a technical definitional issue around the assets or services that the AER considers should be subject to a revenue decrement. The AER's rule change refers to a revenue decrement arising from the use of:


*assets forming part of the regulatory asset base for the provision of services other than the provision of standard control services.*

This means that assets which are used to provide alternative control services could potential give rise to a revenue decrement if those assets remain in the regulated asset base established under Part C of Chapter 6. This would be inappropriate as such services would be subject to a separate control mechanism.<sup>56</sup>

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<sup>55</sup> Commission's directions paper, p. 65.

<sup>56</sup> Ausgrid, *Submission in response to AEMC consultation paper*, December 2011, p. 33.



The Commission concludes that this exclusion appears to be appropriate.<sup>57</sup> Jemena supports that conclusion.

Set out below are examples of shared standard control assets that are used in the provision of other services, including unregulated services.

- *public lighting* – The AER has classified public lighting services as alternative control services in the Victorian DNSPs' recent EDPR determination. The majority of street lights are attached to power poles as distinct from dedicated public lighting poles. Use of assets for public lighting services should be excluded from the uses for which consumers should receive compensation.
- *security light* – Another example relates to the provision of security lighting services (watchman lighting), where the lights are either attached to private building structures or power poles. The AER has classified the provision of security lighting as an unregulated service. In Jemena's opinion, this type of use should be excluded on the basis that the benefits would not exceed the costs. In Jemena's case, we do not have accurate records of the numbers of security lights that are mounted on power poles and the administrative burden of apportioning the cost of the power poles to security lighting services is likely to outweigh the value of compensation.
- *shared poles* – Victorian DNSPs and tramway companies have quid pro quo arrangements for the shared use of each other's poles. Jemena considers this type of use should also be excluded from the uses for which consumers should receive compensation.

### **4.3 Jemena's answers to the Commission's questions 7 to 19**


#### *Question 7*

*In what circumstances would an NSP need to spend more than its allowance under the NER?*

In section 4.2.3, we explained that the term "allowance" implies that the capex forecast has an unjustified quality of absolute truth. It suggests that the forecast is in fact the business's efficient costs, so, if the business operates efficiently, that "allowance" will only be exceeded in exceptional circumstances. The "allowance" is no more than a forecast. The heading to section 6.5.7 of the NER—Forecast Capital Expenditure—says as much.

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<sup>57</sup> Commission's directions paper, p. 65.



A forecast is necessarily the product of judgement and there are many reasons why a forecast may be exceeded: it may simply be that the forecast was wrong or unreasonable. Even if the forecast was reasonable and the best available at the time it was made, the only certainty is that the actual outcome will be different, and the differences are likely to be greater the longer the time horizon of the forecast. For example, a significant proportion of capex is driven by demand growth and new connections which are in turn a function of many factors including general economic conditions and government policies. Expenditure to meet demand growth and new connections is not discretionary. While other, discretionary, capex might be deferred to compensate for non-discretionary capex exceeding forecast, that deferral can only be temporary and may well be inefficient.

#### *Question 8*

*What is the best option for dealing with the capex incentive issues identified in this paper?*

Jemena supports making changes to the NER to give the AER guided discretion to choose between using forecast and actual depreciation in the roll-forward calculation but with a presumption in favour of using forecast depreciation if there is a capex EBSS.

#### *Question 9*

*How does using actual or forecast depreciation to determine the RAB affect an NSP's behaviour?*

Using actual depreciation in the RAB roll-forward calculation results in an incentive which varies with the life of the assets involved. The penalties for expenditure on short-lived assets that occurs early in the regulatory period are particularly severe. The outcome for the NSP is dependent on the level of expenditure at the asset class level, not just at the aggregate level.


When forecast depreciation is used, the outcome is independent of asset life.

#### *Question 10*

*The Commission notes the comments by the ERAA on the need for a rigorous approach to assessing capex reopeners and contingent projects. The Commission seeks submissions from retailers on any other options for minimising the impact of capex reopeners and contingent projects on retailers.*

The purpose and effect of capex reopener and contingent project regimes is to confirm an NSP's entitlement to recover costs if/when specified circumstances arise and conditions are satisfied. That being the case, the only remaining





question is when the costs will be recovered. If certainty during the current regulatory period is considered a priority then the only option is to defer implementation until the beginning of the next period. In that case, the NSP should also be compensated for the cost of the deferral.

#### *Question 11*

*More extensive use of the uncertainty regime means regulatory arrangements more closely resemble commercial contracts. Is this appropriate?*

As a matter of principle, network users should pay the efficient cost of providing the services that they demand and use. More extensive use of uncertainty regimes will lead to a more equitable sharing of risks between NSPs and network users.

#### *Question 12*

*To what extent would stronger capex incentives, through an EBSS for example, deal with incentives for an NSP to inefficiently change its capitalisation policy during a regulatory control period?*

In section 4.2.6 we observe that a well-constructed capex EBSS can and should be calibrated so that, together with other incentive arrangements, there is a balanced incentive to optimise capex, opex and service performance.

#### *Question 13*


*How, and to what extent, does the incentive for an NSP to overspend or underspend vary depending on whether it uses a related party or not having regard to the other incentives for efficient capex, including the scope for the AER to determine efficient capex at the regulatory determination?*

In section 4.2.6 we observe that private sector NSPs face significant constraints on expenditure and that the existence of related party margins is unlikely to affect materially the inclination or incentives for a group that includes both the NSP and related provider to provide capital. The level of margin approved by the AER in its ex-ante review determines the amount that the NSP and hence the group will recover from network users, irrespective of the group's costs.

#### *Question 14*

*To what degree would a parent company of an NSP be better off if related party margins, that are higher than those allowed for by the AER in the regulatory determination, are due to genuine higher costs?*

If costs are genuinely higher than can be recovered through the level of margins allowed by the AER then a group that includes both the NSP and related provider



must be in deficit when taken as a whole, irrespective of the level of margin actually paid.

*Question 15*

*Should the AER be given the power to develop and implement pilot or test incentive schemes within a controlled environment?*

Giving the AER power to develop and pilot test new schemes is a sensible option. However, the AER's immediate priority should be to develop improved incentive schemes for capex and demand side participation projects for which the NER already allows.

*Question 16*

*What limits should be placed on the extent of these schemes?*

It should not be open to the AER to impose a test scheme on a business. Test schemes should be designed and developed in consultation with NSPs; testing should only be conducted with the agreement of the affected business(es); and the amount of revenue at risk should be small.

*Question 17*

*Should the concept of compensation for consumers for use of shared assets be applied to transmission, as well as distribution?*

If the concept of compensation for consumers for use of shared assets is applied to distribution then there is no reason in principle why it should not also be applied to transmission.

*Question 18*

*Stakeholders have suggested use of assets for alternative control services should be excluded from the uses for which consumers should receive compensation. Are there any other examples of such uses?*

Jemena supports the suggestion that the use of assets for alternative control services should be excluded from the uses for which consumers should receive compensation.

### Question 19

*What are the appropriate guiding principles allocating compensation arising from sharing assets between regulated and unregulated services?*

In Jemena's submission in response to the Commission's consultation paper on the AER's and EURCC's proposals, we proposed a set of principles that should guide any decision by the AER on the amount of revenue to be shared with consumers. Any sharing arrangement must:

- apply only to revenues after netting off all relevant costs, including the risks associated with the use of standard control assets
- take into account the detrimental effect of any form of sharing on the incentives of DNSPs to develop such alternative sources of revenue
- be developed so as to minimise the associated regulatory burden
- be applied in such a way that new forms of unregulated service are granted a sharing holiday for, say, a minimum initial period – of perhaps 3 or 5 years
- provide a basis for deciding the amount of revenue to be shared with Consumers
- disregard services that are unlikely to be material
- be designed so as to be proportionate to the amounts involved.<sup>58</sup>

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<sup>58</sup> Jemena's submission in response to the Commission's initial consultation paper, 8 December 2011, p. 109.

## 5 Rate of return frameworks for both electricity and gas

### Key points:

- Given the major contribution of the cost of capital building block to revenue, certainty and predictability for this parameter is particularly important.
- Recent experience has shown that flexibility is important, and needs to be balanced with the desire for certainty.
- The current electricity distribution and gas distribution frameworks, in general, have coped well in striking that balance.
- Improvements can be made to ensure that the approach to evolving WACC estimates is more iterative and more regular.
- Unnecessary cost can be avoided by providing for merits review of the statement on the cost of capital (**SoCC**) or any guideline that may replace it.

### 5.1 The Commission's initial views

#### 5.1.1 *Single national framework*

The Commission's initial preference is for a single framework to be used across all three sectors (not necessarily the same parameter values), but will consider different frameworks for electricity and gas service providers.

#### 5.1.2 *Adapting to changing circumstances*


The Commission's view is that the current rules in this area are not satisfactory. In particular, the framework to estimate the rate of return for electricity transmission businesses does not provide sufficient flexibility to adapt to changing circumstances. The frameworks for gas and electricity distribution are preferable.<sup>59</sup>

The Commission considers that WACC parameter values can change and evolve over time as evidence and data change.<sup>60</sup> Under Chapter 6, DNSPs are not being unnecessarily advantaged by having the ability to engage with the AER on WACC issues at the time of their determinations. There may be circumstances that justify

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<sup>59</sup> Commission's directions paper. p. 66.

<sup>60</sup> Commission's directions paper. p. 83.



the AER considering whether it should depart from a previously adopted parameter value where the departure would result in a better WACC estimate.

There are a number of positive flexibility features of the NGR framework.

- Requiring the rate of return to be determined at the time of each access arrangement decision means that the AER or ERA can effectively have regard to current market circumstances.<sup>61</sup>
- The ability to apply other WACC definitions and cost of equity models has allowed alternatives to be considered in light of evolving theoretical and empirical evidence. If evidence continues to mount, a point may be reached where alternative models may be warranted if it is more likely to produce WACC estimates that are of a much better quality than is achieved through the current models. Prescribing a particular model in the rules may unnecessarily restrict the regulator from considering evidence or information that would support using alternatives.<sup>62</sup>

### 5.1.3 *Merits review*

The Commission is concerned about the effect of removing NSPs' and gas service providers' access to merits review. The rate of return contributes to a significant portion of NSPs revenues. It is appropriate that there is sufficient regulatory accountability to ensure that any errors potentially made by the regulator are corrected.<sup>63</sup>

### 5.1.4 *Benchmark efficient firm*

The framework(s) will continue to be based on estimating the WACC for a benchmark efficient firm. A benchmark efficient firm could be different for different electricity transmission, electricity distribution and gas service providers.<sup>64</sup>

### 5.1.5 *Level of prescription*

The Commission's preliminary view is that the rate of return framework should not prescribe the methodology or values for parameters, but rather provide guiding principles.<sup>65</sup>

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<sup>61</sup> Commission's directions paper. p. 87.

<sup>62</sup> Commission's directions paper. p. 89.

<sup>63</sup> Commission's directions paper. p. 93.

<sup>64</sup> Commission's directions paper. p. 93.

<sup>65</sup> Commission's directions paper. p. 64.

### 5.1.6 *Ranges for parameter values*

The Commission's view is that the rules should require the regulator to consider using ranges for certain parameter values and linkages between different WACC parameters when it applies them.<sup>66</sup>

## 5.2 **Jemena's response to the Commission's initial view**

### 5.2.1 *Single national framework*

Jemena generally supports a single national framework to setting the cost of capital. Jemena strongly supports the Commission's view that a single framework does not necessarily imply identical parameter values being set for different types of networks. There may be good reasons why a single framework would produce different values for particular WACC parameters, for example, between gas and electricity networks. While these businesses are similar in some respects, they have important differences in others, which may be reflected through, for example, different beta estimates.

A single framework, if implemented, should aim to provide certainty as to the methods used to estimate parameters, while providing sufficient flexibility for different parameter values to be set under the single framework, where appropriate.

### 5.2.2 *Adapting to changing circumstances*


Jemena supports a framework that would appropriately balance flexibility and certainty. Jemena agrees that inflexible parts of the electricity transmission framework have made it difficult for regulated businesses and the AER to determine an appropriate cost of capital during an unusual period in the financial markets.

Jemena's experience with the gas and electricity distribution frameworks is that, in general, both frameworks have functioned well, providing both sufficient certainty and flexibility. Jemena believes that a good way to balance certainty and flexibility is to:

- provide for a level of flexibility similar to that in the current gas or electricity distribution rules (chapter 6), and
- adopt an iterative, precedent-based approach to setting the cost of capital.

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<sup>66</sup> Commission's directions paper. p. 64.



This will ensure that any evolution of the cost of capital estimation comes from a sound and certain base and is developed and implemented gradually, giving businesses time to make any necessary adjustments to how they fund investment.

In section 7.2.3 of this submission, we propose that all electricity NSPs' regulatory price reviews be aligned into an annualised calendar. Among other things, this would enable the AER to issue with its final decisions each year an incremental update on its position on WACC methodologies and parameters—an annual statement on the cost of capital. This update would occur at the same time every year and take account of current and emerging market conditions.

This annual incremental approach should avoid the potential for significant unexpected changes in the WACC methodologies and parameters from year to year, while allowing for new insights and data to be incorporated progressively.

### *5.2.3 Merits review*


Jemena agrees that merits review is a crucial part of the regulatory framework. It provides accountability and supports the certainty of the regime. Jemena believes that much of the cost of overlapping merits reviews relating to WACC could have been avoided if the framework had allowed for a merits review of the AER's decision on the SoCC.

Without this possibility, even though at the time the AER's first SoCC was issued in 2009 most regulated businesses disagreed with the outcome, each individual business was forced to challenge aspects of the SoCC decision at the time the SoCC was being applied through that business's pricing determination. A lower cost approach, had the framework allowed for it, would have been for the businesses to jointly challenge the SoCC in a single review process at the time the SoCC was published.

### *5.2.4 Benchmark efficient firm*

Jemena agrees that the cost of capital, like other costs that make up the building blocks regulatory framework, should continue to be estimated for a benchmark efficient firm.

It is important to remember that the aim of the regulatory regime is to promote efficient outcomes—to encourage firms to move to the efficiency frontier of providing network services. Each business's journey to the frontier will be different—some businesses may be the best at gaining efficiencies in their field operations and capital programs, others may be good at obtaining economies of



scale and scope by integrating multiple businesses into a single coherent group, while others still may be particularly good at sourcing funding.

It is difficult to know which specific aspects of a particular business are efficient or inefficient. This is the reason incentive regulation exists—rather than second guessing particular aspects of a business's operations, the incentive framework uses the concept of an overall benchmark-efficient firm and sets tariffs to allow the costs of such a firm to be recovered. The individual regulated business then does its best to maximise profit within those constraints, and it is the business that is best placed to decide which areas offer the best opportunity for improvement.

There is, therefore, no reason to separate the cost of capital out of the overall framework of incentive regulation.

#### *5.2.5 Level of prescription*

Jemena supports an appropriate balance between certainty and flexibility. Given the large contribution that the cost of capital building block makes to revenue, it is particularly important that there is a high degree of certainty and predictability around the WACC parameters.

Certainty and predictability are created when the rules place appropriate limits on the regulator's discretion, as well as setting up transparent and accountable processes for the exercise of the discretion that has been allowed.


Jemena believes that a good way to balance certainty and flexibility is to define high-level methodologies in the rules, with the detail of those methodologies to be set out in a binding document (such as a guideline or a SoCC) that evolves iteratively through its application to price reviews and is updated on, perhaps, an annual basis.

In principle, the current level of prescription in the electricity and gas distribution rules could remain largely unchanged. The electricity distribution framework could benefit from additional discretion to consider cost of equity models other than the capital asset pricing model (**CAPM**).

#### *5.2.6 Ranges for parameter values*

Jemena does not support the use of ranges, unless high-prescription low-discretion rules set out exactly how the AER must select a point estimate within the range. There is no avoiding the fact that a point estimate is required to determine tariffs. Explicitly providing for setting a range, with high discretion to select a figure within that range, would simply reduce the certainty and predictability of the current regime for no apparent benefit.





An interesting approach voluntarily adopted by the New Zealand Commerce Commission is to use the 75<sup>th</sup> percentile of a WACC range. This point estimate, rather than the mid-point, is used to explicitly recognise the fact that the costs to the economy of any potential under-investment due to underestimating the WACC are likely to be higher than the costs of potential over-investment due to overestimating the WACC.

### 5.3 Jemena's answers to the Commission's questions 20 to 29

#### Question 20

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

While some parameters are more stable than others, recent experience shows that none of the parameters are likely to be sufficiently stable to be fixed with a high degree of confidence for a number of years into the future. Jemena would support that any review of the WACC should allow for each parameter to be reviewed. It is important, however, that while the rules should provide for a review of all parameters, the discretion to change a parameter should only arise where good reasons exist for such a change.

#### Question 21

*Would it be useful if the AER periodically published guidelines on its proposed methodologies on certain WACC parameters as opposed undertaking periodic WACC reviews that locks in parameter values for future revenue/pricing determinations?*

In Jemena's view, it is not important whether the selected mechanism is a periodically published guideline or a WACC review statement. What is important is the need for the particular mechanism to promote certainty and predictability in the regulatory regime. This will only occur if the mechanism limits the regulator's discretion by setting out binding detailed methodologies and, potentially, the parameters that would result from applying those methodologies.

Jemena supports an approach that would be more iterative than the current five-yearly review. An annual process that takes into account recent pricing determinations may be appropriate.



#### Question 22

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

As noted above, there is no way of avoiding the need for a point estimate of the WACC. Providing additional discretion to subjectively select that point estimate from a range would simply reduce certainty in the regime for no apparent benefit. If the rules were to provide for a range, they would need to be highly prescriptive about how the regulator must select a point from that range.

Jemena believes that the rules, as they currently stand, do not prevent the AER from recognising and accounting for interrelationships between various WACC parameters.

#### Question 23

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

In practice, the WACC decisions in gas and electricity have been highly consistent. It is not clear whether this is an inherent feature of the rules, or whether this is simply because the AER administers both sets of rules.

#### Question 24

*How has the rate of return framework under the NGR worked alongside the NER frameworks?*

See answer to question 23 above.

#### Question 25

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

See answer to question 23 above. Jemena does not have any concerns on the level of guidance in the NGR.

#### Question 26

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

*Jemena is not aware of any reasons to adopt another definition.* Question 27

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

Jemena supports the current level of discretion in the NGR to consider alternative models. Given the high level of uncertainty in estimating the benchmark efficient cost of equity, information provided by additional models can, at the very least, be used as a cross-check on the CAPM estimates and, where those alternative models can be shown to be superior, to substitute the CAPM estimates.

#### Question 28

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

Jemena is not aware of any such reasons, provided that the framework is designed to recognise variances across the different industries.

#### Question 29

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

If a single framework were to be adopted, appropriate attributes could be drawn from chapter 6 of the NER, as well as specific attributes of the NGR—in particular, the ability to consider alternative cost of equity models.

## 6 Cost of debt for both electricity and gas

### Key points:

- How the cost of debt is dealt with in the rules can be improved, though it is important to consider and, where appropriate, retain the precedent and guidance provided to date.
- While it is reasonable to review from time to time the benchmark for estimating the cost of debt, there is no evidence to suggest that the current benchmark needs to change.
- Certainty and predictability should be encouraged either through the rules or through binding guidelines that are subject to the accountability mechanism of merits review.
- The EURCC's proposed trailing average approach to **the total cost of debt** is flawed and should not be adopted, yet the concept of a trailing average approach to the **debt risk premium** component of the cost of debt warrants further investigation which would take more time than the rule change process allows for.

### 6.1 The Commission's initial views


#### 6.1.1 *Current approach is problematic*

The Commission shares the view that the current approach to the cost of debt in the NER is problematic, though it does not agree there should be a different approach depending on whether an NSP is government-owned or privately-owned.<sup>67</sup>

The requirement in the NER regarding the estimation of the DRP has resulted in significant debate and merits review processes around an appropriate choice of data to satisfy the required benchmark definition. The problem appears to be compounded by the fact that the term-to-maturity and the credit ratings specified by the AER for comparable Australian corporate bonds in its 2009 WACC review no longer appear to be appropriate to match the nominal risk free rate. This is

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<sup>67</sup> Commission's directions paper. p. 96.



because the number of long-term Australian corporate bonds on issue has contracted significantly since the onset of the GFC.<sup>68</sup>

However, the Commission cannot conclude that NSPs are currently being over-compensated by the cost of debt allowances.

### *6.1.2 Specification of the benchmark*

The specification of an appropriate benchmark, at a conceptual level, should not be driven by specific data availability issues.<sup>69</sup> The Commission is initially cautious about specifying a DRP benchmark in the NER.<sup>70</sup>

The regulator should have the flexibility to re-specify the benchmark when it appears that the observed cost of debt is consistently above or below the benchmark allowances.<sup>71</sup>

### *6.1.3 Level of prescription*

The Commission's initial view is that the cost of debt methodology should not be detailed in the rules, but should be determined by the regulator.<sup>72</sup>

### *6.1.4 Trailing average approach*

Using the trailing average approach to estimate the cost of debt as proposed by the EURCC has merit, although it will require consideration of some fundamental principles that underpin the existing rate of return frameworks.<sup>73</sup>

The Commission is seeking further comments and analysis on whether the EUCC's proposal to use the trailing average approach to estimate the cost of debt should be an option available to the regulator under the rules.<sup>74</sup>

The Commission would like to explore the possibility of allowing the rules to permit, but not require the regulator to consider, and if appropriate adopt, an option such as this.<sup>75</sup>

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<sup>68</sup> Commission's directions paper. p. 118.

<sup>69</sup> Commission's directions paper. p. 111.

<sup>70</sup> Commission's directions paper. p. 109.

<sup>71</sup> Commission's directions paper. p. 119.

<sup>72</sup> Commission's directions paper. p. 96.

<sup>73</sup> Commission's directions paper. p. 119.

<sup>74</sup> Commission's directions paper. p. 96.

<sup>75</sup> Commission's directions paper. p. 96.

## 6.2 Jemena's response to the Commission's initial view

### 6.2.1 *Current approach is problematic*

Jemena agrees that the estimation of the cost of debt has been a contentious issue and improvements can be made to the current approach. It is important to remember however that, under the current framework, much progress has been made, with the Australian Competition Tribunal providing guidance that is yet to be fully implemented. It is important to consider the value of that precedent when considering whether to make any changes, which would effectively remove the body of precedent created through the accountability processes of the current framework.

### 6.2.2 *Specification of the benchmark*

Jemena agrees that specifying the benchmark at a conceptual level should not be driven by data availability issues. Jemena also agrees that the specification of the DRP benchmark should be reviewed from time to time. However, any changes need to be based on robust evidence and be subject to the accountability mechanism of merits review. Jemena notes that the current rules provide for flexibility for the AER to adopt a different credit rating and term to maturity, should the current settings be no longer appropriate.

### 6.2.3 *Level of prescription*

Jemena supports a framework that provides certainty and predictability for the regulated businesses. Such a framework would limit discretion by detailing the cost of debt methodology in a binding document (such as a SoCC or a guideline), with the AER's decision on such a document being subject to the accountability mechanism of merits review.

### 6.2.4 *Trailing average approach*

Jemena believes that the EURCC's proposed approach to a trailing average is deeply flawed and therefore not appropriate. In particular, the EURCC proposal is to apply the trailing average concept to the **total cost of debt**, which simply does not reflect the reality of how businesses structure their debt and, in particular, exposes the regulated businesses to intra-year movements in the risk free rate.

However, the concept of a trailing average approach to **the debt risk premium** in principle warrants further investigation. The issue is complicated and requires more time to work through than is available in this consultation process. Adopting any version of a trailing average approach would be a material change and would require Jemena to seriously re-consider its current approach to raising and hedging

debt for the business. Transitional arrangements would also need to be put in place in order to recognise the way in which regulated businesses have structured their debt under the existing framework. Jemena refers the Commission to the ENA's submission on this issue and the supporting report from NERA<sup>76</sup>.

### **6.3 Jemena's answers to the Commission's questions 30 to 34**

#### *Question 30*

*Is the benchmark DRP approach likely to overstate the prevailing cost of debt, having regard to the suggestion that the overstatement may be a reflection of shorter maturity debt leading to a higher refinancing risk for NSPs? What weight should be placed on the views of market analysts on the ability of stock market listed NSPs to out-perform their cost of debt allowances?*

Jemena refers the Commission to the ENA's submission on this issue, supplemented by relevant expert reports. The submission notes that:

- there is no evidence that the current DRP benchmark does not reflect current financing practices of regulated businesses, and
- that the equity market analysis reports do not support a conclusion that NSPs out-perform their cost of debt allowances, and
- where NSPs do out-perform the cost of debt allowances, there are likely to be valid reasons, such as greater refinancing risks being borne by shareholders, or individual features of the particular NSP (such as the benefit of an implied guarantee from a parent entity).

#### *Question 31*

*What are the pros and cons of the recent approaches taken by IPART and the ERA in estimating the DRP?*

Jemena refers the Commission to the ENA's submission on this issue, supplemented by relevant expert reports. The submission notes that the current rules do not prevent the AER adopting the approaches currently used by IPART and the ERA. However, the approaches used by those two regulators have material flaws.

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<sup>76</sup> NERA, *Trailing average approaches to the cost of debt allowance, A joint report for the Energy Networks Association*, April 2012. Provided as Appendix E of the ENA submission on the directions paper.

### Question 32

*What evidence is there that the DRP benchmark in the NER may have changed? Would it be appropriate for the regulator to specify the DRP benchmark in any periodic reviews or would it be more appropriate to specify it at the time of the determinations?*

Jemena refers the Commission to the ENA's submission on this issue, supplemented by relevant expert reports. The submission notes that there is no evidence to suggest that the DRP benchmark needs to change. Nevertheless, there is provision under the current rules to make such a change, should it become necessary. Jemena believes that the DRP benchmark, like all other parameters, should be set through an iterative approach, subject to the accountability mechanism of merits review. This could involve annual updates to a binding guideline/SoCC, as well as iterative decisions on individual pricing determinations.

### Question 33

*Is the EURCC's proposal of establishing the cost of debt using historical trailing average compatible with the overall framework for estimating a forward-looking rate of return? What are the potential benefits of using a trailing average and do they outweigh the potential costs if the estimate is less reflective of the prevailing cost of debt for NSPs?*

Jemena refers the Commission to the ENA's submission on this issue and the supporting report from NERA<sup>77</sup>. As noted in section 6.2.4 above, while the EURCC's proposal is flawed, and not workable, the concept of a trailing average for the debt risk premium in principle warrants further investigation.

Given the complexity of establishing a workable trailing average approach, the current rule change process does not provide enough time to adequately examine all relevant considerations and propose a workable mechanism, including transitional arrangements, which will no doubt be required.

### Question 34


*What possible changes would be required in the NER to implement the EURCC's trailing average approach?*

Jemena does not consider that the EURCC approach should be implemented. However, if over time an appropriate trailing average approach to the DRP proved

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<sup>77</sup> NERA, *Trailing average approaches to the cost of debt allowance, A joint report for the Energy Networks Association*, April 2012. Provided as Appendix E of the ENA submission on the directions paper.





to be appropriate and was adopted, at least the following changes to the rules would likely be needed:

- separating the risk free rate used to estimate the cost of debt from that used to estimate the cost of equity
- developing a revised overarching principle, to apply solely to the debt element of the WACC, that the cost of debt should reflect the concept of the “average historical financing costs of a benchmark efficient NSP”
- potentially, creating and defining an annual pass-through mechanism to allow the trailing DRP to be annually updated, and
- establishing empirical estimates of the DRP over the period of the trailing average, which coincides with the period of the GFC and its disruptive effects on both the quality and quantity of bond yield data.

## 7 The regulatory process for electricity

### Key points:

- Ideally, the NER would simply set out the basic process, deliverables and timeframes. The AER, NSPs and stakeholders would then conduct themselves collaboratively and in accordance with good regulatory practice to identify and resolve the inevitable wrinkles that will appear over time.
- There are some simple steps that can be taken to relieve most of the current pressure points in the regulatory process.
- One is to amend the rules for the regulatory process timetable to:
  - bring forward its commencement by three months
  - incorporate some additional steps to facilitate better stakeholder engagement, and
  - align regulatory processes for all the NSPs into a regular annual calendar.


### 7.1 The Commission's initial views

#### 7.1.1 *Objective of the regulatory process*

The Commission affirms that well-designed procedural requirements enable the regulator to administer the regulatory regime in an appropriate manner by providing for:

- opportunities for regulated businesses and interested stakeholders to make submissions to the regulator
- full and thorough analysis of the submissions and the regulator's decisions (including draft decisions)
- appropriate time constraints to ensure that regulatory decision-making is timely and efficient.<sup>78</sup>

<sup>78</sup> Commission's directions paper, p. 122.



Transparent decision making in this way is conducive to reducing regulatory risk and decreasing the administrative costs of regulation.

### *7.1.2 Three process-related capex and opex factors*

#### *Moving and changing the factors*

As explained in section 3.1.3 in this submission, the Commission's initial view is that it would be appropriate to move the "procedural" factors in the way proposed by the AER and to clarify that the factors are not exhaustive.

#### *AER's obligation to publish its analysis*

In terms of the reference to publication of analysis by the AER, the NER should be amended to make it clear there is an obligation on the AER to publish its analysis with its draft or final regulatory determinations, but no obligation to do so prior to this.<sup>79</sup>

### *7.1.3 NSP submissions during the regulatory process*

The Commission believes that a reason why the regulatory determination process does not appear to have worked as intended is that NSPs have submitted a much greater quantity of material to the AER after the draft regulatory determination than was envisaged.<sup>80</sup> The late submissions provided by NSPs appear to be contributing to a broader problem with the current regulatory determination process in that the process is not providing an opportunity for all stakeholders to effectively scrutinise material provided by NSPs.<sup>81</sup>

The Commission considers a number of options to alleviate the problem that involve extending or bring forward the process, adding some additional steps and/or restricting the scope of NSP submissions.<sup>82</sup>

### *7.1.4 Confidential information*

It is important that the probative value of as much of an NSP's initial or revised regulatory proposal as possible is able to be tested with stakeholders.<sup>83</sup> The Commission will seek to ensure the NER provides scope for as much testing and

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<sup>79</sup> Commission's directions paper, p. 33.

<sup>80</sup> Commission's directions paper, p. 128.

<sup>81</sup> Commission's directions paper, p. 129.

<sup>82</sup> Commission's directions paper, p. 130.

<sup>83</sup> Commission's directions paper, p. 135.



scrutiny of initial or revised regulatory proposals as possible, while upholding legitimate claims of confidentiality by NSPs.<sup>84</sup>

The Commission considers it unlikely that all aspects of an initial or revised regulatory proposal could legitimately be claimed to be confidential, bearing in mind that NSPs are monopolies and do not therefore compete directly with other businesses. There also appears to be scope for information to be aggregated where concerns about confidentiality for more detailed aspects of information are present.<sup>85</sup>

The AER appears to have existing powers under the NEL and common law to use discretion in determining the weight to be given to confidential information in initial or revised regulatory proposals.<sup>86</sup>

### *7.1.5 Framework and approach paper*

#### *Can be optional*

The framework and approach paper stage should be optional, with the appropriate trigger to be considered further. Incentive schemes should remain part of the framework and approach paper. It may be appropriate to include in the paper the proposed sharing mechanism to allow consumers to be compensated where distribution assets are used to provide non-standard control services.<sup>87</sup>

#### *Departures from framework approach paper (or last AER decision)*

“Unforeseen circumstances” appears to be an appropriate trigger for allowing changes to a control mechanism or service classification set in the framework and approach paper.

### *7.1.6 Material errors in regulatory determinations*

After the final regulatory determination is made it should only be able to be changed as a result of merits review outcomes or in very clear and exceptional circumstances. Therefore, the Commission is in favour of keeping the scope of the material error provisions narrow and focussed on “computational” errors or situations where an NSP has submitted false or misleading information.<sup>88</sup>

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<sup>84</sup> Commission’s directions paper, p. 136.

<sup>85</sup> Commission’s directions paper, pp. 135-6.

<sup>86</sup> Commission’s directions paper, p. 136.

<sup>87</sup> Commission’s directions paper, p. 142.

<sup>88</sup> Commission’s directions paper, p. 146.



The Commission requires more support prior to broadening the types of material errors or deficiencies under Chapter 6 by which the AER may revoke and substitute regulatory determinations.<sup>89</sup>

The difference in benefits between the AER, on the one hand, amending a determination, and, on the other hand, revoking and substituting it, is not very clear. However, the power to amend regulatory determinations will impact on the NSP's ability to have this reviewed in a merits review.<sup>90</sup>

#### **7.1.7** *Timeframes for cost pass through, contingent projects and capex reopener applications*

##### *Stop the clock mechanism*

A “stop the clock” mechanism for the AER should be explored further for addressing complex pass through and capex reopener applications. However, the Commission does not consider that it should also be applied to contingent project applications as it is unclear when complex circumstances could arise for these types of applications<sup>91</sup>

##### *Dead zone*

The time between an “event” occurring and the submission of an application to the AER will require consideration of how an event is characterised. This may link to the rule change request on pass throughs, submitted by Grid Australia, which the Commission is also currently considering.

## **7.2 Jemena’s response to the Commission’s initial view**

### **7.2.1** *Objective of the regulatory process*

Jemena fully supports the Commission’s view on the nature of well-designed procedural requirements and that transparent decision making is conducive to reducing regulatory risk and decreasing the administrative costs of regulation.


Like many issues the AER raises in its rule change proposal, the extent to which the regulatory process achieves outcomes that promote the NEO depends on factors within and outside the NER. Ideally, the NER would simply set out the basic process, deliverables and timeframes. The AER, NSPs and stakeholders would then conduct themselves collaboratively and in accordance with good

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<sup>89</sup> Commission’s directions paper, p. 147.

<sup>90</sup> Commission’s directions paper, p. 146.

<sup>91</sup> Commission’s directions paper, p. 146.



regulatory practice to identify and resolve the inevitable wrinkles that will appear over time. In doing so, the NER could be less prescriptive and more flexible to deal with unforeseen circumstances, and the parties could concentrate on dealing more effectively with matters of substance.

Jemena has very much appreciated a recent opportunity to gather feedback from the AER on Jemena's conduct during the recent reviews. We are confident this feedback will enable us to improve our practices and make our submissions clearer, timelier and more accessible to the AER and stakeholders.

In his expert report for the ENA, Mr Geoff Swier sets out a number of initiatives that the AER and NSPs may initiate to enhance the operation of the NER<sup>92</sup>:

- *early planning* – the AER and NSPs can establish a common understanding of the issues associated with the regulatory process during dialogue at the early stages of planning
- *guidelines* – the AER can consult on and publish non-binding guidelines on:
  - the form and timing of submissions
  - identification and management of confidential information
- *limited disclosure* – a system that would allow NSPs to disclose certain confidential information under controlled circumstances to enable stakeholders to comment on it
- *issues paper* – the AER can publish an issues paper on NSPs' initial regulatory proposals to signal to stakeholders the areas upon which it seeks particular comment.

We deal with the implications of each in subsequent sections of this submission.

Jemena's experience and Mr Swier's findings highlight that opportunities to procure and learn from feedback, and for regulatory processes and practices to mature, take time and communication.

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<sup>92</sup> Geoff Swier, *Assessment of proposed changes to regulatory process and practice rule, Rule change request by the Australian Energy Regulator: Economic regulation of network service providers, Expert report for the Energy Networks Association*, 16 April 2012, pp. 5-8.

## 7.2.2 *Three process-related capex and opex factors*

### *Moving and changing the factors*

For reasons Mr Swier sets out in his expert report for the ENA<sup>93</sup>, moving the "procedural" factors in the way proposed by the AER and clarifying that the factors are not exhaustive would change the standards that apply for the analysis and justifications that need to be provided in the AER's determinations. We also concur with Mr Swier's analysis and conclusions that the Commission should not change the standard.

### *AER's obligation to publish its analysis*

In terms of the broader issue of regulatory process, expectations of good regulatory practice and procedural fairness, rather than prescriptive rules, should govern whether the AER has an obligation to consult on material upon which it relies for its decisions. Accordingly, we do not support the Commission making a rule that makes it clear the AER has no obligation to publish its analysis other than with its draft or final regulatory determinations.

When affirming its policy intent and deciding this issue, the Commission has the opportunity to articulate its expectations of good regulatory practice and procedural fairness, and the roles that all parties have in achieving that. We encourage the Commission to do so and to indicate the type of consequences (e.g. less flexible rules) that may ensue if its expectations are not met. All the parties involved will then have an incentive to participate constructively because it avoids undue regulatory intervention and potential cost.

## 7.2.3 *NSP submissions during the regulatory process*

When examining the AER's rule change proposal and the factors that lead to NSPs making additional submissions, the Commission has highlighted practical pressure points in the regulatory process set out in the NER including:

- the volume of information from the NSPs that the AER needs to deal with and consult on, and stakeholders' ability to understand that information
- the time NSPs need to prepare their revised regulatory proposals and resource constraints during the Christmas period

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<sup>93</sup> Geoff Swier, *Assessment of proposed changes to regulatory process and practice rule*, 16 April 2012, pp. 22-6, Attachment F of ENA, *Response to directions paper*, 16 April 2012.

- the opportunity NSPs and other stakeholders have to respond to new issues raised by stakeholders in submissions on the revised regulatory proposals
- the time DNSPs need to prepare and consult on their pricing proposals after the AER's final determination
- the flexibility the AER, NSPs and stakeholders need to deal with new information that becomes available during the later stages of the process due to exceptional circumstances
- the challenges the AER experience in resourcing a large number of reviews.

In Jemena's view there are some simple steps that can be taken to relieve these pressure points, even the ones that the Commission believes are currently outside the scope of its review of the AER's rule change proposal. There is less to be gained from amending the regulatory process in a manner that ignores some clear areas of need.

#### *Volume and timing of information*

Necessarily, the regulatory process requires a lot of complex information. The main drivers of the volume of information that Jemena has submitted in its regulatory reviews have been the AER's regulatory information notices (**RINs**) and its subsequent information requests. During JEN's review, the AER issued it with two very large RINs: one just prior to its initial regulatory proposal and one just after the AER's draft decision. As difficult as RINs can be to develop and comply with, Jemena supports the AER's right to make such requests and takes seriously its legal and non-legal obligations to comply in a timely manner.

The need to lodge materials to support a possible merits review is a consideration but not a major driver to the volume of information Jemena has submitted to the AER. Our priority has always been to provide information that is necessary to enable the AER to make a robust decision in the first place.

With time and more understanding of what is most relevant to regulatory decision making, we are confident that the AER's RINs and information requests will become more targeted. Jemena is also learning how to present its information in a manner that enables the AER to easily navigate through and use it.

Accordingly at this stage, we see no need for a rule change to specifically limit the volume of information *per se*.



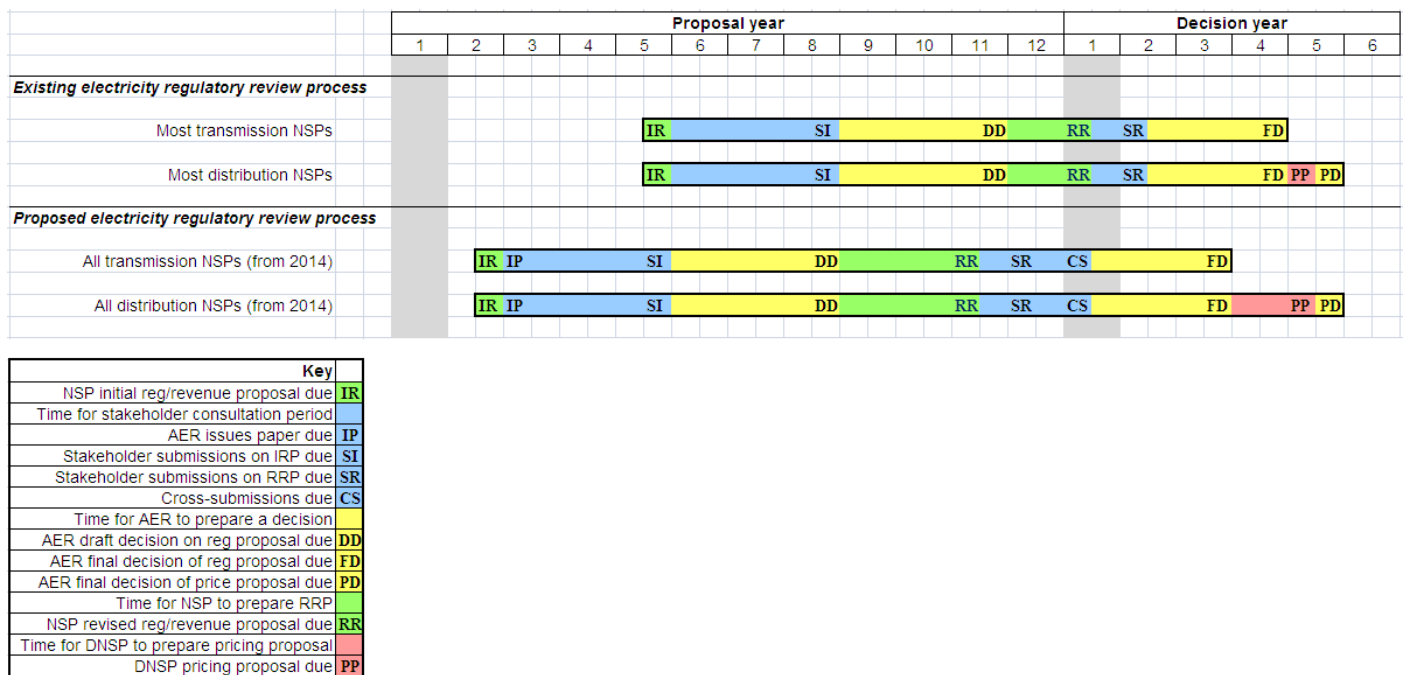
### Amending and annualising the process timeframes


In response to several of the Commission’s pressure points, Jemena proposes that the regulatory process timetable set down in the rules be amended to:

- *extend and add steps* - commence the regulatory process three months earlier to allow:
  - the AER to publish an issues paper on an initial regulatory proposal
  - an additional month for NSPs to prepare their regulatory proposals
  - a month for stakeholder cross-submissions on the revised regulatory proposal
  - a month more for NSPs to prepare and lodge their pricing proposals
- *annualise timetable for all NSPs* – from 2014, align the regulatory processes for all NSPs into a regular annual calendar.

The amended and annualised timetable Jemena proposes is shown in Figure 7.1.

**Figure 7.1 – Proposed amended regulatory process**





Aligning the regulatory processes for all NSPs into a regular annual calendar could enhance outcomes by enabling the AER, NSPs and stakeholders to:

- more effectively plan and manage their resources
- more readily compare and learn from the outcomes of each annual round of review—perhaps in an annual evaluation report—and continually improve the process and their practice.

An annualised calendar would enable the AER to issue with its final decisions each year an incremental update on its position on WACC methodologies and parameters—an annual statement on the cost of capital. This update would take account of current and emerging market conditions.

An annualised calendar would also have the effect of aligning the regulatory periods of all NSPs on a common July-June financial year. JEN would be one of the NSPs that would need to change its regulatory period, which is currently based on calendar years. Its next regulatory review process would have to be delayed by 6 months and transitional arrangements to deal with pricing and incentive schemes would need to be developed. Jemena is prepared to work with the Commission and the AER to achieve that.

#### *Guideline for exceptional circumstances*

Jemena agrees with Mr Swier that the AER has the opportunity to set out in a guideline an appropriate means of dealing with new information that may arise late in the process in exceptional circumstances<sup>94</sup>.

#### *7.2.4 Confidential information*

##### *Reasons for substantial amount of confidential information*

NSPs must submit a considerable amount of confidential information to the AER to support its decision making. Most is provided in response to the AER's RINs and information requests.

An NSP's information can be commercially sensitive even though it does not compete with other businesses to provide its services. The information can be confidential because its disclosure has the potential to damage the NSP's commercial interests—for example its ability to negotiate with contractors and suppliers—or to breach confidentiality obligations that the NSP has to others.

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<sup>94</sup> Geoff Swier, *Assessment of proposed changes to regulatory process and practice rule*, 16 April 2012, p. 35.

### *Process improvements*

From our experience, there is significant potential to improve the manner in which NSPs claim confidentiality and we support the development of a confidentiality protocol that seeks to achieve that improvement.

Jemena also supports Mr Swier's proposal that stakeholders are provided with access to NSPs' confidential information subject to appropriate controls and confidentiality undertakings.<sup>95</sup>

### *7.2.5 Framework and approach paper*

#### *Can be optional*

Jemena confirms its support for the framework and approach paper to be optional and only initiated by the AER or a DNSP:

- if one of them believes there is evidence that a change to the DNSP's service classification or price control is necessary and there is merit in determining this prior to the preparation of an initial regulatory proposal, or
- where an NSP or jurisdictional government asks the AER to make an earlier determination of an NSP-specific or jurisdictional issue.

Increasingly, the AER will conduct its design and application of incentive schemes on a national basis rather state-by-state, and its actual framework and approach will evolve year-by-year with each review. This will reduce even more the need for a framework and approach paper.


The time and effort the AER, NSPs and stakeholders expend to develop and respond to framework and approach papers can be better used in other parts of the regulatory process.

#### *Departures from framework approach paper (or last AER decision)*

While some businesses seek certainty as to their service classification and control mechanism in a framework and approach paper before they finalise their regulatory proposals, Jemena has a different view. Like a gas access arrangement, we see a regulatory proposal as an integrated package for which many of the elements of our offering to the regulator are interdependent. Pre-determination of discrete elements has limited utility to us, and can be burdensome and impractical.

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<sup>95</sup> Geoff Swier, *Assessment of proposed changes to regulatory process and practice rule*, 16 April 2012, p. 43.



An example occurred in the AER's 2009 framework and approach paper in relation to its classification of some alternative control services for Victorian DNSPs. Not until the AER examined the DNSPs' regulatory proposals in full did it become apparent to the AER that its classification had created an issue in relation to standard connection services.

Accordingly, Jemena supports the opportunity for DNSPs to skip the framework and approach paper and to put forward their service classification and control mechanism as part of their regulatory proposal.

#### *7.2.6 Material errors in regulatory determinations*

Jemena agrees with the Commission that, at this stage, there is no evidence to support a rule change to broaden the types of material errors or deficiencies under Chapter 6.


In its 8 December 2011 submission, Jemena explained a case in which the AER had made an error and declined the opportunity to revoke and remake its decision<sup>96</sup>. We can confirm that Jemena has legal advice which supports the view that the AER had sufficient power under rule 6.13 to do so both before and after Jemena initiated its merits review.

Under rule 6.13 the AER is permitted to (but is not required to) revoke a distribution determination during a regulatory control period if it appears to the AER that the determination is affected by a "miscalculation". In the case we quote on 8 December 2012, the error was that the AER had not annualised the BBB and AAA rated fair value yields it had sourced from Bloomberg for the purpose of calculating JEN's debt risk premium.

From our advice, when the AER considers revoking and remaking one of its decisions, only two potentially awkward issues arise: (a) whether the AER's power to correct an error or deficiency is limited to being exercised once the regulatory period to which the relevant distribution determination applies has commenced, that is, if the determination is for the 2011-2015 regulatory control period, whether the AER must wait until that period commences before correcting the error; and (b) whether, if an NSP or intervener has sought merits review on the same matter that the AER is considering for revocation and substitution, the AER retains jurisdiction in respect of that matter.

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<sup>96</sup> Jemena's submission in response to the Commission initial consultation paper, 8 December 2011, pp. 94-5.



Our view is that, if the need for the AER to correct a miscalculation is clear, these potential issues can be readily overcome. In any case, the AER's proposed rule change does address them.

Accordingly, in our view, chapter 6 currently adequately allows the AER to address computational errors or situations where an NSP has submitted false or misleading information and no rule change is justified.

### *7.2.7 Timeframes for cost pass through, contingent projects and capex reopener applications*

#### *Stop the clock mechanism*

Jemena continues to support a "stop the clock" mechanism whereby the AER may suspend its consideration of an application while it seeks more information, consults with stakeholders or awaits the outcome of a related process (e.g. the Victorian Bushfires Royal Commission). This approach is targeted at the AER's concerns and would enable the AER to extend timelines only with reference to a specified and significant external event.

No rule is necessary to compel NSPs to advise the AER of an event and possible pass-through application. NSPs have an interest in notifying the AER early to ensure their application receives proper attention and this should be a matter of good practice.

#### *Dead zone*


Bringing forward and extending the regulatory determination process—as Jemena proposes in section 7.2.3 of this submission—lengthens the time between lodgement of a regulatory proposal and commencement of the new regulatory period: the so-called "dead zone". A pass through event may occur during this period and leads to an NSP incurring costs in its subsequent regulatory period. As the rules are currently drafted, it may not be possible for an NSP to:

- amend its regulatory proposal to incorporate these new costs
- apply for a cost pass through with respect to that event in the following regulatory period.

The rule change proposal that Grid Australia lodged in October 2011 deals with this issue.<sup>97</sup>

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<sup>97</sup> Grid Australia, *Rule Change Proposal – Cost Pass Through*, October 2011.



If the regulatory determination process is brought forward and extended as we propose, there will be an even greater need for the rules to adequately deal with pass through events occurring in the dead zone.

### **7.3 Jemena's answers to the Commission's questions 35 to 40**

#### *Question 35*

*What factors or principles would promote an effective regulatory determination process?*

Jemena fully supports the Commission's view on the nature of well-designed procedural requirements and that transparent decision making is conducive to reducing regulatory risk and decreasing the administrative costs of regulation.

Like many issues the AER raises in its rule change proposal, the extent to which the regulatory process achieves outcomes that promote the NEO depends on factors within and outside the NER. Ideally, the NER would simply set out the basic process, deliverables and timeframes. The AER, NSPs and stakeholders would then conduct themselves collaboratively and in accordance with good regulatory practice to identify and resolve the inevitable wrinkles that will appear over time. In doing so, the NER could be less prescriptive and more flexible to deal with unforeseen circumstances, and the parties could concentrate on the dealing more effectively with matters of substance.

#### *Question 36*

*Which option(s) would be the best way of addressing problems with the regulatory determination process?*

There are several problems with the regulatory determination process. Given that the frequency of rule changes should be kept to a minimum, it would be preferable that the Commission address all currently identifiable problems with the process at the same time using the most elegant solution.

The AER and the Commission have identified some of the problems:

- the AER's reluctance to be obliged to publish and consult on its analysis
- handling large volumes of information some of which arrives later in the process
- the time allowed for NSPs to prepare revised regulatory proposals and for stakeholder consultation

- dealing efficiently with confidential information
- balancing the certainty and rigidity of the framework and approach paper
- processing complex applications for cost pass through, contingent projects and capex reopener
- allowing sufficient time for NSPs to develop and consult retailers and customers on their pricing proposals.

Jemena can suggest others:

- the timeliness, magnitude and frequency of the AER's RINs
- the uncertainty about the nature and volume of other information the AER requires NSPs to submit to support their regulatory proposals
- the frequency and urgency of AER information requests and questions on NSPs' regulatory proposals.

None of these issues are anything more than what one would expect to arise in the first round of reviews. Some will be resolved with experience.

In hindsight, the best holistic solution would take account of all the problems that require a rule change. Given that the Commission is constrained to examine only those issues raised by the AER, Jemena has explained in section 7.2 above its preferred solution to each problem on which the Commission has sought comment.

#### *Question 37*

*Are there any other options that could address the issue of providing adequate time for consultation and assessment during the regulatory determination process?*


We set out in section 7.2 above our proposal for bringing forward, extending and annualising the regulatory review timetable.

#### *Question 38*

*Should the AER be given more time to consider confidentiality claims in initial and revised regulatory proposals?*

There is no explicit time constraint on the AER to consider confidentiality claims.

As explained in section 7.2 above, there is an opportunity for NSPs and the AER to more efficiently manage confidential information and we believe this could be set



down in a guideline developed collaboratively by the AER with NSPs and stakeholders.

*Question 39*

*Should the NER be clarified to reflect the NEL and/or common law position with respect to the AER's ability to give weight to confidentiality claims in initial and revised regulatory proposals?*

No, as explained above, and in more detail in the ENA's submission, the NER and the NEL already adequately provide for the extent to which the AER may place weight on submissions.

*Question 40*


*Alternatively, are there any other additional ways to address confidentiality claims in initial and revised regulatory proposals that are not currently available under the NER?*

Yes, as explained in above, we believe a guideline can resolve many issues associated with the claiming and treatment of confidential information.



## Appendix 1 – Glossary

ACT (or Tribunal)	Australian Competition Tribunal
AER	Australian Energy Regulator
capex	capital expenditure
CAPM	capital asset pricing model
DNSP	distribution network service provider
EBSS	efficiency benefit sharing scheme
DRP	debt risk premium
EDPR	electricity distribution price review (Victoria)
ENA	Energy Networks Association
EURCC	Energy Users Rule Change Committee
F&A paper	framework and approach paper (issued by the AER)
JEN	Jemena Electricity Networks (Vic) Ltd
JGN	Jemena Gas Networks (NSW) Limited
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
NSP	network service provider
EURCC	Energy Users Rule Change Committee
opex	operating expenditure



PV	present value
RAB	regulatory asset base
RIN	regulatory information notice (issued by AER)
SoCC	Statement on Cost of Capital
Tribunal (or ACT)	Australian Competition Tribunal
WACC	weighted average cost of capital