grid australia
BACKBONE OF THE NEM

8 December 2011

Mr John Pierce
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

Via website: www.aemc.gov.au

Dear John

Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011

Grid Australia welcomes the opportunity to provide this submission to the Australian Energy Market Commission (AEMC) in response to the above Rule change proposals submitted by the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC).

Grid Australia's members have a direct and substantial interest in the matters addressed in the proposed Rule changes.

Grid Australia's members are also members of the Energy Networks Association (ENA). The ENA has lodged a submission on the proposed Rule changes and Grid Australia endorses the positions taken in that submission to the extent they apply to electricity transmission.

Importantly, the ENA submission includes three reports from a panel of economic and legal specialists with particular expertise in economic regulation. These reports, referred to as the Joint Experts Reports, address the following issues:

- Expenditure forecasting;
- Capital expenditure incentive arrangements; and
- The weighted average cost of capital (WACC).

A fourth report has also been provided by Gilbert and Tobin on the regulatory decision making process. Grid Australia has drawn on the analysis in these Joint Expert Reports and the Gilbert and Tobin report and refers to the conclusions of these reports throughout this submission.

Grid Australia considers there are a number of important contextual matters that are relevant to the AEMC's assessment of the Proposed Rule Changes, these include:

- The current Rules were intended to enhance regulatory certainty;
- The current Rules are achieving their intended outcomes; and
- The need for a stable, transparent and certain environment for major investment in network infrastructure has not diminished.

Grid Australia considers that the majority of problems that the AER assert to exist with the current framework are not supported by the evidence. The AER's Rule Change Proposal also does not appear to have given due consideration to the appropriate level of prescription and discretion within the context of Australia's institutional framework in which traditional regulatory discretion is split between the AER and a separate 'rule maker' (AEMC). This means in some instances the AER has sought to provide itself with excessive discretion while in others it is clear that proper regard has not been given to existing discretions available to it.

Therefore, aside from a limited number of exceptions, Grid Australia does not support the proposals put forward by the AER. One notable exception is with respect to the guidance in the Rules on the cost of debt, where Grid Australia acknowledges the difficulties that have arisen with applying the previous standard approach during the recent periods of material financial market uncertainty.

Regarding the EURCC proposed Rule change, again the recent difficulties with estimating the cost of debt during the recent financial market uncertainty are at the heart of the EUCC Rule change proposal, which Grid Australia acknowledges (while noting that large aspects of the EUCC's analysis is not supported).

Grid Australia welcomes the AEMC's proposed framework for assessing the Proposed Rule Changes and considers that the framework focuses on ensuring that a sound evidence-based assessment is undertaken against the National Electricity Objective (NEO) and the Revenue and Pricing Principles.

Grid Australia looks forward to continuing to work with the AEMC and stakeholders through the further stages of the Rule change process. If you require any further information, please do not hesitate to contact me on (08) 8404 7983.

Yours sincerely

Rainer Korte

Rainer Korte
Chairman
Grid Australia Regulatory Managers Group

grid australia
BACKBONE OF THE NEM

Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011

Response to AEMC Consultation Paper

December 2011

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1. Introduction and Overview

Grid Australia welcomes the opportunity to provide this submission to the Australian Energy Market Commission (AEMC) in response to the Consolidated Rule Change Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011 (Proposed Rule Changes) comprising proposed Rule changes submitted by the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC).

As the AEMC is aware, Grid Australia represents the owners of all major electricity transmission networks in the National Electricity Market (NEM). Collectively, this group own and operate over 47,000 km of high voltage transmission lines with a combined value of $12 billion and delivering an annual investment program of approximately $2.2 billion. As a result, its members have a direct and substantial interest in the matters addressed in the Proposed Rule Changes.

Grid Australia's members are also members of the Energy Networks Association (ENA). The ENA has lodged a submission on the Proposed Rule Changes and Grid Australia endorses the positions taken in that submission to the extent they apply to transmission. Importantly, the ENA submission includes three reports from a panel of economic and legal specialists with particular expertise in economic regulation. These reports, referred to as the Joint Experts Reports, address the following issues:

- Expenditure forecasting;
- Capital expenditure incentive arrangements; and
- The weighted average cost of capital (WACC).

A fourth report has also been provided by Gilbert and Tobin on the regulatory decision making process.

Grid Australia has drawn on the analysis in the Joint Expert Reports and the Gilbert and Tobin report and therefore refers to their conclusions throughout this submission.

1.1 Context for the AEMC's assessment

Grid Australia considers there are a number of important contextual matters that are relevant to the AEMC's assessment of the Proposed Rule Changes, these include:

- **The current Rules were intended to enhance regulatory certainty** – Chapter 6A was intended to enhance the certainty and predictability of the regulatory framework for electricity transmission from what existed under the previous regime, and thereby create an environment conducive to efficient long term investment in electricity transmission infrastructure. This was achieved by elevating to the Rules key parts of the regime and by providing guidance and principles to be applied by the AER when exercising its discretion. Using the Rules to promote certainty and predictability was complementary to the then recent institutional reforms, whereby traditional regulatory discretion is split between the AER and a separate 'rule maker' (AEMC) who has the ability to make and change rules expeditiously guided by the Law (including the National Electricity Objective (NEO)). Grid Australia considers that fundamental change to the regulatory framework just five years since the last review would place enhanced certainty and predictability at risk, unless compelling evidence is provided of a need for change.

- **The current Rules are achieving their intended outcomes** – As no transmission business has yet completed a regulatory control period under the current Rules, Grid Australia cautions that it is too early to draw strong inferences about the operation of the Rules to date. Nevertheless, based on the information available to date many of the AER's claims about the problems in the current regime appear unfounded. Further to this, there is evidence which demonstrates that the changes made to the Rules by the AEMC are delivering the outcomes that were intended. In particular, under the current Rules substantial transmission investment has been undertaken in order to meet growing energy demand, to manage the impact of climate change policies, to replace old assets, and to expand the network into new areas. This challenge has been met in an environment of sound risk management and cost containment by the businesses.

- **The need for a stable, transparent and certain environment for major investment in network infrastructure has not diminished** – there are considerable future challenges for transmission networks, not least in managing the impacts of climate change policies on Australia's energy system. It is these future challenges, rather than any fundamental flaw in the regulatory framework that will be the major driver for price rises for customers in coming years. Grid Australia therefore cautions the AEMC and stakeholders to be realistic about their expectations as to the outcomes of the current Rule change process. These challenges also underscore the continued importance of a certain and predictable regulatory regime.

1.2 Summary of responses to detailed Proposed Rule Changes

Grid Australia considers that the majority of problems that the AER assert to exist with the current framework are not supported by the evidence. Therefore, Grid Australia considers that in most cases a prima facie case for a change to the current regulatory framework has not been made. The AER's Rule Change Proposal also does not appear to have given due consideration to the appropriate level of prescription and discretion within the context of Australia's institutional framework noted above. This means in some instances the AER has sought to provide itself with excessive discretion while in others it is clear that proper regard has not been given to existing discretions available to it. Therefore, aside from a limited number of exceptions, Grid Australia does not support the proposals put forward by the AER. One notable exception is with respect to the guidance in the Rules on the cost of debt, where Grid Australia acknowledges the difficulties that have arisen with applying the previous standard approach during the recent periods of material financial market uncertainty. A summary of Grid Australia's views on the Proposed Rule Changes is provided below.

Regarding the EURCC proposed Rule change, again the recent difficulties with estimating the cost of debt during the recent financial market uncertainty are at the heart of the EURCC Rule change proposal, which Grid Australia acknowledges (while noting that large aspects of the EURCC's analysis is not supported). However, the EURCC's proposal for different principles to apply to private and government owned businesses would generate a number of inefficient outcomes and not meet the NEO and ultimately the needs of customers. A separate aspect of the EURCC proposal is to switch from providing a cost of debt allowance that reflects the 'spot rate' to one that reflects the 'embedded cost'[1] for a benchmark financed entity. While this would amount to a major change from the current approach and raise a series of complex issues, Grid Australia supports further analysis of this proposal during this review.

1.2.1 Capital and operating expenditure forecasts

Setting estimates of required expenditure

Grid Australia does not support the AER's proposed changes to setting estimates of required expenditure on the basis that the AER has not provided evidence of a problem. Contrary to the AER's assertions, the evidence indicates that:

- The AER has undertaken whatever assessment it considers necessary to properly assess forecasts
- The AER has not been constrained in its ability to revise forecasts, having made substantial cuts to proposed expenditure forecasts, and
- The AER does not face a 'burden of proof', but instead there is a practical hurdle for the network businesses to provide sufficient evidence to satisfy the AER and for the AER's decision as to whether or not it is satisfied to be based upon evidence.

Accepting the AER's proposed Rule changes would remove a number of important features of the existing framework. In particular, it will reduce the incentive for the

1 The term 'embedded cost' refers to the interest rate payable on a portfolio of debt that was raised over a historical period.

businesses to submit fully articulated and accurate proposals and the requirement for the AER's decision to be based on evidence.

Expenditure objectives, factors, and criteria

Grid Australia agrees with some aspects of the AER's proposed changes to the process and evidentiary aspects of the expenditure factors. However, Grid Australia does not consider that removing the requirement to have regard to 'the individual circumstances of the business' provides the right balance between prescription and discretion. This is because it would remove an important consideration that should be taken into account when setting forward looking costs for an individual business. Grid Australia recommends that the Rules are clarified so that the AER is required to have regard to relevant exogenous factors that influence the operation of a transmission network service provider's (TNSP) business.

1.2.2 Incentive arrangements

Capital expenditure incentives

Grid Australia acknowledges that there are shortcomings with the current incentive arrangements for capital expenditure and that it is appropriate to explore refinements. However, the capital expenditure incentive arrangements proposed by the AER have a number of serious flaws:

- The incentive power of the scheme is uncertain given it varies according to whether a network business expects to spend more than its regulatory allowance.
- The scheme is asymmetric and so does not provide an equal incentive for efficiency gains. This asymmetric penalty on overspending may lead to TNSPs inefficiently deferring, or avoiding, otherwise efficient and necessary investment.
- The scheme does not provide a continuous incentive across regulatory years.

Grid Australia notes that the AER already has the ability to introduce a capital expenditure efficiency benefit sharing scheme for distribution, and considers that the extension of the same capacity for transmission should be explored. However, prior to doing so, Grid Australia considers there should be a review of the current criteria to ensure that the AER is guided in all the matters that are relevant to the application of such a scheme to transmission.

Option to develop other incentive schemes

The proposal from the AER to give itself a general power to implement other incentive schemes is inconsistent with the regulatory framework that exists in the NEM. The Rules already provide the AER with discretion regarding the detailed design of specific classes of incentive schemes. The Rule proposed by the AER would allow it to bypass important criteria and safeguards that are built into the framework for developing incentive schemes.

Actual and forecast depreciation

Grid Australia considers that the option to apply actual depreciation in the roll forward of the regulatory asset base is a second best option to developing a well-functioning capital expenditure scheme. Therefore, at a minimum, the Rules should provide flexibility about whether actual or forecast depreciation is applied. Moreover, the AEMC may also wish to consider the appropriateness of prescribing the use of forecast depreciation given the limitations the application of actual depreciation places on achieving a well-balanced incentive framework.

1.2.3 Cost of Capital

Process for setting the WACC

Grid Australia supports a process whereby WACC parameters or methods are set by the AER in a Statement on the Cost of Capital (Statement) every five years, and continues to combine electricity transmission and distribution. However, the challenges of recent years in setting the WACC provide strong argument for Chapter 6A to be changed to accommodate exceptional circumstances. Grid Australia notes that the framework for Chapter 6 already provides a mechanism to accommodate GFC type events.

- Standard approaches for setting the WACC failed during the GFC, and experience has shown that a ‘safety valve’ that permits departures from inputs or methods in a Statement is essential to cope with such events.

- The AER’s proposal to bring forward the review of the Statement could not address GFC-type issues.

It is also incongruous that the errors that have been found in the 2009 WACC Statement (some of which were later conceded by the AER) must continue to be applied to new determinations for TNSPs.

Guidance on setting WACC parameters including the cost of debt

Grid Australia agrees that problems emerged during the Global Financial Crisis with deriving a benchmark debt risk premium from the Australian corporate bond market, and that it is appropriate for the Rules to permit additional classes of information to be considered. However, the discretion the AER seeks is unnecessarily wide. Key constraints for determining the cost of debt – namely that it reflects a benchmark for an Australian borrower, with the benchmark assumptions (term and credit rating) transparently disclosed – should remain. There is also merit in removing the need for the same risk free rate to be used to estimate the cost of equity and the cost of debt.

More broadly, the AER's Rule change proposal demonstrates that there is inadequate guidance in the Rules for many of the WACC parameters, with much of the initial guidance effectively overwritten by the 2009 WACC Statement. Further guidance in the Rules should be considered to ensure the AER is properly guided. Grid Australia also considers it is essential for the 'persuasive evidence' threshold that applies before a value, methodology or credit rating in a new Statement can change from the previous Statement to remain.

Turning to the EURCC rule change proposal, Grid Australia considers that many of its conclusions and recommendations are flawed.

- Its recommendation that owner-government borrowing costs be applied for government owned firms ignores the risk that tax payers bear from these activities and ignores the downstream resource misallocation that would arise where different network charges result purely on account of ownership. More specifically, lower network charges in States where networks are government owned would distort the location decisions of major energy users and potentially lead to inefficient over-consumption in those jurisdictions.

- Its conclusion that current allowances for the debt risk premium provide excessive returns because they exceed the historical debt costs ignores the difference between allowances that reflect the 'spot' interest rate on debt (which is the current regulatory practice) and one based on embedded debt costs (which is what the EURCC ultimately proposes).

However, Grid Australia supports giving further consideration to changing to a regime whereby the debt allowance reflects the embedded cost of debt for a benchmark financed entity, which is an important component of the EURCC proposal. That said, this would be a material change to the regime and potentially gives rise to material implementation issues. Moreover, a number of important issues would need to be addressed, which include:

- whether the 'embedded' component should relate to the whole cost of debt or just the risk premium element

- how the benchmark debt cost at any point in time is to be determined, and

- whether prices should continue to be revised during the regulatory period to reflect the change in borrowing costs as the efficient portfolio is refinanced over time, or whether the debt allowance should be based in part upon forecasts.

1.2.4 Regulatory Decision Making Process

Submissions during a determination process

Grid Australia considers that the Rule proposed by the AER relating to submissions from network businesses during a revenue determination process is overly prescriptive and restrictive. It is important for effective regulatory decision making that the AER and third parties are provided with sufficient information to undertake assessments. Grid Australia considers there are a number of legitimate reasons for network businesses to provide information at times outside the formal proposal or revised proposal periods. Therefore, the AER's proposal only acts to increase the risk of it having insufficient information and thereby the risk of regulatory error. This may ultimately lead to an otherwise avoidable use of expensive appeals mechanisms.

Grid Australia also considers that, from a practical perspective, the 30 business day timeframe to prepare a Revised Revenue Proposal is extremely tight. There would clearly be merit in extending this timeframe to address practical difficulties for TNSPs as well as other stakeholders.

Correcting for material errors

Grid Australia is concerned that changes proposed by the AER in this area may reduce the certainty and finality of the final determination. While Grid Australia supports the proposed alignment between the distribution and transmission Rules regarding the extent to which a determination can be corrected, it has concerns about the AER's other proposed changes. In particular:

- The proposed drafting change to allow the AER to 'amend' a determination means that the part of the determination affected by the error would not be subject to the same type of process, and safeguards, involved in making the original determination.

- The proposed extension of the scope of matters subject to a revocation and substitution of a revenue determination to a 'deficiency' provides the AER with discretion considerably in excess of the previous arrangements thereby significantly increasing risk for network businesses.

Timeframe for the assessment of cost pass through events, contingent projects and capex reopeners

Grid Australia agrees that some assessments are complex and may need more time. However, the AER proposal may be unduly prescriptive and restrictive. Therefore, Grid Australia endorses the alternative 'stop the clock' provision outlined in the ENA submission as a possible solution noting that other options may also exist to address this issue.

1.3 Framework for responding to the Proposed Rule Changes

The AEMC in its Consultation Paper for the Proposed Rule Changes has asked stakeholders to respond to four key questions, which in broad terms are:

- Whether participants agree with the nature of the problem

- Whether the proposal achieves the right balance between prescription and discretion
- Whether the AER could already achieve the outcome sought through the use of existing discretion, and
- Whether the solution proposed is the preferred solution, or whether a more preferable solution exists.

Grid Australia welcomes the AEMC's proposed framework for assessing the Proposed Rule Changes and considers that the framework focuses on ensuring that a sound evidence-based assessment is undertaken against the National Electricity Objective (NEO) and the Revenue and Pricing Principles.

Grid Australia has in this submission sought to address each of the Proposed Rule Changes under each of the themes identified in the Consultation Paper. On that basis, the remainder of this submission will address the Proposed Rule Changes grouped under the following headings:

- Context for the AEMC's assessment
- Capital and expenditure forecasts
- Incentive arrangements
- Cost of capital
- Regulatory decision making processes.

The EURCC proposal is addressed under the cost of capital section of this submission.

2. Context for the AEMC's assessment

Before directly addressing the specific proposals put forward by the AER and the EURCC, Grid Australia considers that it is important to provide some relevant context to the debate about how the Rules operate and their role in the regulatory framework. To this end, this section:

- Sets out the background to the development of the existing Rules
- Comments on the effectiveness of the current Rules in encouraging efficient outcomes
- Provides observations on the appropriate level of prescription or discretion in the Rules, and
- Supports the AEMC's proposed framework for assessing the AER's Rule change proposal.

2.1 Existing Rules were introduced to provide long term certainty to unlock investment

- Certainty and predictability of regulation are essential for transmission, as the investments are recovered over decades, spanning multiple price/revenue reviews.
- The regime in place prior to Chapter 6A provided the ACCC with a very wide discretion with respect to the regulation of transmission revenues. This discretion – combined with the manner in which the ACCC exercised that discretion – created serious concerns about the predictability and certainty of transmission revenue regulation.
  - A key objective of the AEMC's last review was to use the rules to provide the level of certainty and predictability required to underpin long term investment in transmission.
- Substantial investment has followed the AEMC's previous review, but in an environment of cost containment. However, a substantial investment challenge remains to replace ageing assets, meet demand growth and to respond to the changing generation mix. The need for certainty and predictability remains as strong as it was at the time of the AEMC's last review.

- None of the TNSPs have had a full regulatory period under the new Chapter 6A. Fundamental change to the regulatory regime just five years since the last review would place the enhanced certainty and predictability of regulation at risk, unless compelling evidence is provided of a need for change.
- Expectations need to be realistic about the impact of the current review on future prices. Meeting the cost of recent investments, and the future challenges, will place inevitable pressure on prices to rise.

2.1.1 Current Rules were intended to enhance regulatory certainty

Certainty and predictability in the regulatory framework are essential prerequisites for encouraging efficient long term investment in electricity transmission infrastructure. Transmission assets tend to have physical and economic lives that are upward of 40 years. Costs for network assets are typically recovered over similarly long timeframes. In addition, the assets required to provide transmission services have limited, or no, viable alternative uses. The implication of these factors is that regulatory outcomes can have a considerable influence on the risks faced by network businesses, and hence the incentives for future investment. Indeed, the expected payoffs from new investments will need to withstand multiple regulatory reviews and decisions.

The National Electricity Law (NEL) required the AEMC to review, and to the extent necessary, amend the National Electricity Rules (Rules) governing the regulation of transmission revenue and prices before 1 July 2006. The requirement for the AEMC to review the Rules for the economic regulation of networks followed long running concerns about the quality of the former regulatory regime in providing guidance to the ACCC, particularly with the breadth of discretion provided to the ACCC and the manner in which it exercised that discretion.

At the time of the AEMC's review, the framework for the economic regulation of transmission networks was very different to what exists today. The ACCC had multiple roles – it was the economic regulator of transmission networks and also had the role of approving (through its authorisation requirement) any changes to the National Electricity Code (NEC), the precursor to the Rules. Moreover, the guidance for the ACCC from the NEC was poor – it contained multiple, competing objectives, and was restricted to the level of high level principle.

Given the breadth of its discretion, the ACCC sought to provide industry participants with more certainty as to how it would exercise its discretion through the development of a guideline. However, while a draft statement was released in 1999, it was not finalised until 2004. Between 1999 and 2004 the Draft Statement of Regulatory Principles for the Regulation of Transmission Revenues (DSORP) was applied by the

ACCC in revenue determinations. Its non-binding status in law – and the fact that it remained in draft form for so long – substantially reduced the extent to which it was able to provide the long term certainty and predictability in the regulatory regime that is essential to underpin long term investment. Indeed, as Grid Australia members have noted previously, the ACCC did depart from its DSORP on numerous occasions, crystallising fears about the lack of certainty. The inconsistency of decisions under the previous framework, and the need for improved certainty was identified in a number of submissions when the ACCC reviewed the DSORP in 2003. The ElectraNet submission reflected the views of other stakeholders when it stated:[2]

> *"The ACCC has now almost completed regulatory reviews for each of the TNSPs including TransGrid, Energy Australia, Powerlink, ElectraNet, SPI PowerNet and Transend.*
>
> *In each of these reviews, the ACCC has confirmed the approach on certain issues outlined in the DRP and on other issues has moved away from the position set out in the DRP.*
>
> *Such changes by the regulator underscore the degree of uncertainty and regulatory risk that exists for investors who make long-term investment decisions based on the regulatory rules in place at the time.*
>
> *While ElectraNet recognises that the Regulatory Principles will likely need to evolve over time, their finalisation is necessary to improve the certainty of the regulatory framework and, as a result, enhance the strength of the incentives provided by that framework."*

A submission from Transend to this process also identified concerns about a lack of certainty in the framework:

> *"Transend is also concerned that, in establishing Transend's present revenue cap, the Commission on the one hand seems to want to apply a clawback approach to all "within period" capital expenditure efficiencies, and on the other hand is contemplating an efficiency carry-over mechanism for capital expenditure. These two positions are incompatible with one another. In Transend's view, this demonstrates that the basic elements of the Commission's regulatory framework are still uncertain. At this stage of the regulatory process – some four years after the draft SoRP was published – this is a serious concern."*

A report released by the Commonwealth Government just prior to the AEMC's review underscored the future investment challenges for the energy sector, and the implications for governments (including regulators):[3]

> *"Demand for energy in Australia is projected to increase by 50 per cent by 2020, and the energy industry has estimated that at least $37 billion in energy investments will*

[2] ElectraNet SA, *Submission to the ACCC Review of Draft Principles for the Regulation of Transmission Revenues,* 28 November 2003, p. 5.

[3] Department of Prime Minister and Cabinet, *Securing Australia's Energy Future,* 2004, p.2

be required by 2020 to meet the nation's energy needs. Meeting this increased demand for energy, while moving to a low-emissions future, is a key challenge facing Australia's future growth and living standards."

The report proceeded to observe:

"Providing an attractive environment for these investments is a high priority for government. Australian Government policy provides investors with the freedom to act commercially and earn reasonable returns, while compensating the community for the use of its resources and ensuring that environmental and social issues are managed well"

In light of the experience under the previous regulatory regime described above, and the investment challenge confronting the industry, the AEMC identified certainty for participants as one of the key themes for its development of the new rules for the regulation of transmission services.[4]

"1. Aligning the long term incentives of transmission service providers with those of other market participants including end-use customers. It is particularly important that network owners and other investors have appropriate incentives to develop and operate the transmission network in an efficient manner so that prices reflect least cost production and delivery of power to end-users at the levels of reliability and security they require, and

2. Increasing the clarity, certainty and transparency of the regulatory approach, so as to provide a more certain regulatory environment in which investors can make efficient investment decisions which deliver market outcomes that better serve the long term interests of consumers."

The observation that certainty and predictability of regulation is important for encouraging long term investment was also consistent with the views taken in other reviews about the functioning of access regulation at the time. As an example, the Prime Minister's Export Infrastructure Taskforce observed as follows:[5]

"Infrastructure assets are by their nature long lived and involve lumpy investment. Just as there will be periods when assets that have been built ahead of demand are underutilised, so will there be periods of rapid growth in demand that strain the supply/demand balance. That a lengthy period of domestic economic growth, combined with a sharp increase in export demand, has placed pressure on capacity should not in and of itself be a cause for concern.

What is concerning, however, are the difficulties that have been encountered in responding to those pressures by investors in some parts of our infrastructure. If our problem in earlier years was at times profligate investment by government owned monopolies, the risk today is that efficient, commercial investment will be delayed or

4 AEMC, *Review of the Electricity Transmission Revenue and Pricing Rules, Consultation Program, Revenue Requirements: Issues Paper,* October 2005, p.9.

5 Export Infrastructure Taskforce, *Report to the Prime Minister,* 2005, p.6.

even deterred by inappropriate policy settings. Simpler, more transparent, predictable and accountable regulation is of key importance in this respect."

2.1.2 Outcomes under the current Rules

In the next section Grid Australia notes that no transmission business has yet completed a regulatory period under the current Rules and hence cautions that it is too early to draw strong inferences about the operation of the Rules. Subject to this caveat, however, Grid Australia notes that there are grounds which demonstrate that the changes to the Rules are delivering the outcomes that were intended and there is little basis for concern.

In particular, the Rules have, to date, proved to be successful in unlocking the substantial transmission investments required to meet the challenges discussed in the previous section. These challenges have included the need to meet demand growth, to manage the impacts of climate change policies, to replace old assets, to expand the network into new areas and, in some cases, strengthened reliability standards. Indeed, such challenges have been recognised by the AER. In its 2010 State of the Energy Market Report, the AER identified the drivers for increases in forecast network investment, observing as follows:[6]

The key drivers for rising investment include:

- *More rigorous licensing conditions and other obligations for network security, safety and reliability*
- *Load growth and rising peak demand*
- *New connections*
- *The need to replace aging assets, given much of the networks were developed between the 1950s and 1970s.*

Other drivers include changes to system operation due to climate change policies and the introduction of smart meters and grids.

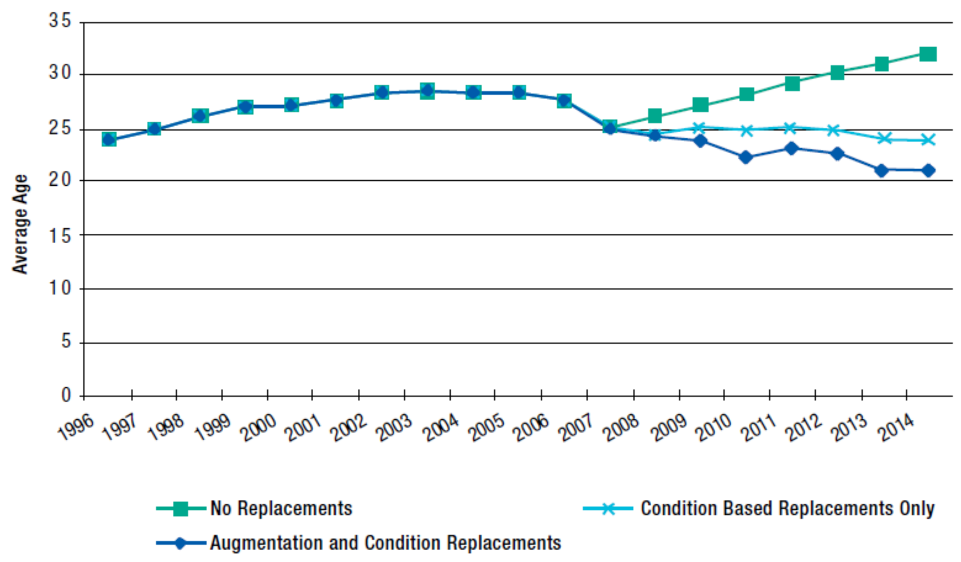
The AER also noted that each network has unique issues relating to its age and technology, its load characteristics, the costs of meeting demand for new connections, and its licensing, reliability and safety requirements.

Replacing old assets has been a particular focus for network businesses. For example, in NSW considerable investment is required simply to keep the average age of assets constant. The figure below highlights that without adequate investment in asset replacement the average age of assets in NSW would steadily increase. Not undertaking investment now would simply delay the problem of aging assets,

[6] AER, *State of the Energy Market: 2010,* December 2010, pp.54-55.

increase the risk of asset failure, and potentially significantly increase the costs of their replacement.

Figure 1: TransGrid Transformer Average Age Forecast



Source: TransGrid Revenue Proposal for 1 July 2009 – 30 June 2014.

Having said that, the increase in transmission investment required to meet the challenges has been achieved in an environment of sound risk management and cost containment by the businesses. While no business has completed a regulatory control period under the current framework, based on present expectations no transmission business with a determination under the current chapter 6A Rules anticipates that actual expenditure will be more than the forecast allowance over the current period. Further, Grid Australia does not consider that any evidence has been provided that demonstrates 'gold-plating' of transmission investments.

2.1.3 Future challenges for transmission networks and implications for prices

While there has been substantial progress made in network investment in recent years, the need for a stable, transparent and certain environment for major investment in network infrastructure has not diminished. Indeed, substantial future challenges exist, which will be the major driver of price rises for customers in coming years rather than any fundamental flaw in the regulatory framework. Therefore, the Proposed Rule Changes cannot solve the issue of rising network prices that are caused by increases in the efficient costs of running a network business.

The AEMC has described the challenges ahead for transmission businesses as part of its Transmission Frameworks Review and drawn an implication for the need for robust frameworks with the appropriate incentives for investment, stating:[7]

> *"While the existing transmission frameworks have delivered investment in network infrastructure, it will be important to ensure that they are sufficiently responsive to the challenges posed by changing patterns of generation and demand side participation in the market.*
>
> *With the potential requirement for significant network investment in the future, Transmission Network Service Providers (TNSPs) will need to react appropriately to the needs of the market. Investment in transmission will need to occur in a timely manner and at locations on the network where it is needed.*
>
> *Robust transmission frameworks with appropriate incentives on TNSPs should help to minimise future risks of uneconomic levels of network congestion. This is critical to provide generation businesses with sufficient certainty to invest in generation assets, as well as delivering security of supply and reliability at least cost to consumers."*

AEMO's National Transmission Network Development Plan (NTNDP) has also recognised the need for substantial investment on the transmission network. In the most recent NTNDP AEMO's scenario modelling identified that between $4 billion and $9 billion of investment is required for national transmission flow paths alone.[8] Specifically, AEMO commented on the need for substantial investment in the shared network:[9]

> *"Growth in the economy and increasing population are driving electricity demand in the NEM. By 2030, this expansion will see our energy consumption increase by 30% to 70% above today's levels. Based on AEMO's scenario modelling, substantial investment is required for augmentation of the shared transmission network and development of new generation assets across the NEM. The majority of this investment is required in new generation assets."*

It follows that irrespective of the outcome of the AEMC's review of the AER's proposed rule changes, meeting the financing costs of the investment that has been required in recent times, and that will be required to meet these future challenges, will inevitably place additional pressure on prices to rise. Grid Australia also notes that this financing task needs to be achieved in an environment of continued uncertainty in financial markets.

In addition, the future challenges for transmission investment underscores the continuing importance of having a regulatory regime that provides the certainty and predictability necessary for investors to have the incentive and capacity to devote the substantial investment funds required.

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7 AEMC, *Transmission Frameworks Review, Directions Paper,* 14 April 2011, p.i.

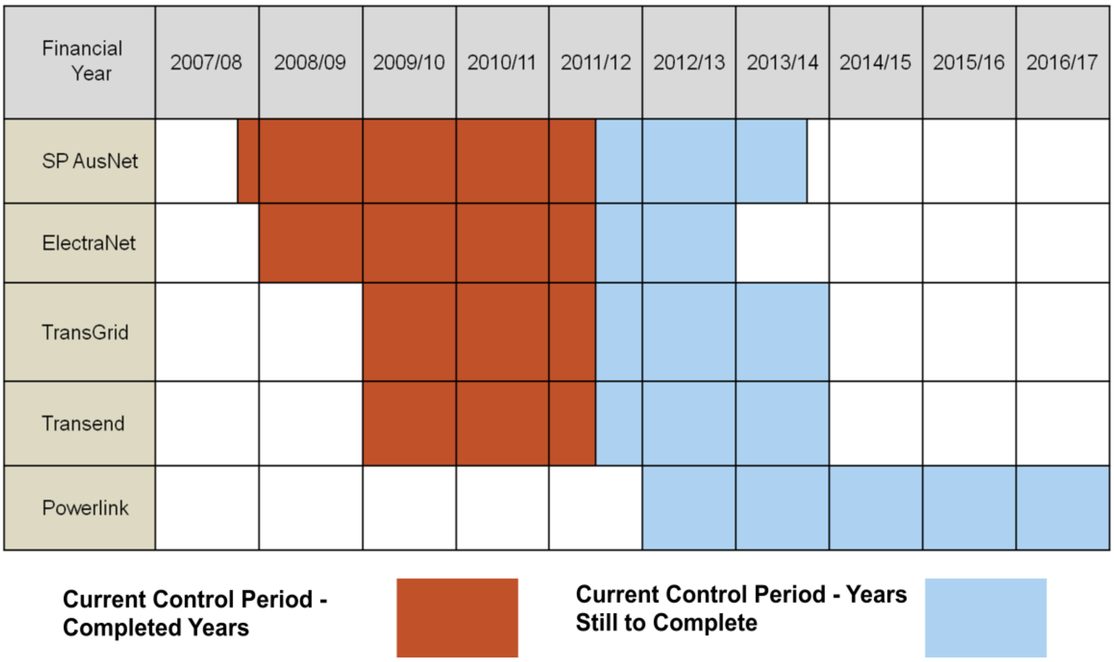
8 AEMO, *2010 National Transmission Network Development Plan,* 2010, , p.35

9 AEMO, *2010 National Transmission Network Development Plan,* 2010, p.i.

2.1.4 The current process and long term certainty

As noted in the previous section, with the exception of Powerlink which is yet to have a determination under the current chapter 6A framework, the Rule change proposal from the AER has been submitted with transmission businesses having only undergone one round of revenue determinations and none of the transmission businesses having completed a single regulatory period under the current framework. The figure below identifies that the majority of businesses are only part way through their regulatory determinations periods and that Powerlink's is yet to commence.

Figure 2: Time under current Chapter 6A Rules for transmission businesses[10]



In addition, none of the transmission businesses have been subject to the weighted average cost of capital (WACC) parameters that were determined by the AER's first review of the WACC under the current Rules.

Given the timing of this review, there is little in the way of evidence from the operation of the regime that can be used to test and draw strong inferences about whether the regime is delivering outcomes consistent with the NEO. In addition, with the AER only just now turning to the second round of decisions, it is difficult to distinguish between adverse outcomes that may have resulted from the AER's challenges in coming to terms with the new regime – and which in turn would fall away as experience grows – from genuine problems with the Rules. Nevertheless, Grid Australia provides

10 Powerlink's current determination was conducted under a transitional arrangement, therefore, it will not be subject to the full contents of the Chapter 6A Rules until its next revenue determination. Note that Powerlink's first regulatory period fully under Chapter 6A commences 1 July 2012.

evidence herein based on the information available to date to demonstrate that many of the AER's claims about the problems in the current regime are unfounded.

More importantly, however, the objective behind the current Rules of enhancing the certainty and predictability of the regulatory framework would be placed in jeopardy if major changes to the framework of the type the AER has proposed were made in the absence of compelling evidence of a need for change. One of the main virtues of the regulatory framework in Australia is that in recent years it has been relatively free from political intervention. However, if a change to the Rules is to be promoted any time that there is political pressure in the face of short-term price rises the integrity of the framework will be significantly compromised. Indeed, investors would have little, or no confidence, that investments they make today will be subject to a similar framework in five years time. This will be to the detriment of efficient investment and consequently the long-term interests of consumers.

2.2 Appropriate degree of prescription in the rules

- The institutional framework for the NEM is unique to Australia and provides the opportunity to use rules to enhance regulatory certainty for industry participants.
  - Traditional regulatory discretion is split in Australia between the AEMC and the AER, and the question is how best to take advantage of the separation of roles between rule making and rule application/enforcement. Simple comparisons of the breadth of the AER's discretion with regulators in other jurisdictions (and whose role is wider) are inappropriate.
- The AEMC considered the issue of prescription of the Rules at length during its last review and achieved the right balance in Chapter 6A. In particular, while the AEMC recognised that regulation cannot be reduced to a mechanical process, the Rules can play a role in enhancing the certainty and predictability of regulation, both through locking in parts of the regime and through providing guidance where discretion remains.

2.2.1 The Australian institutional arrangements

One of the AER's criticisms of the current regime is that it overly constrains the discretion and flexibility of the regulator (the AER). It has contrasted the situation in Australia to other jurisdictions where lawmakers have empowered regulators to apply their own judgement within only high level guidance on how this judgement should be applied.[11]

[11] AER Rule Change Proposal, p.15

However, it is important for any comparisons of the degree of regulatory discretion between Australia and other jurisdictions to take into account the unique features of the institutional arrangements in Australia. The key feature of which is the separation between the rule making function that has been assigned to the AEMC and rule application/ enforcement that is the role of the AER.

As discussed already above, a key driver of the AEMC's creation of the current Rules was an objective of improving regulatory certainty and the quality of economic regulation. However, this task by the AEMC came after a series of institutional reforms in Australia to promote the same objective. The Independent Review of Energy Market Directions (Parer Review) provided the major impetus for changes to the institutional and governance framework in the NEM. In response to the Parer Review, energy Ministers sought to:[12]

- Strengthen the quality, timeliness and national character of governance of energy markets, to improve the climate for investment, and
- Streamline and improve the quality of economic regulation across energy markets, to lower the cost and complexity of regulation facing investors, enhance regulatory certainty and lower barriers to competition.

Following the recommendations of the MCE, the Council of Australian Governments (COAG) endorsed new energy market governance arrangements, which included:

- The MCE as the national policy and governance body for the Australian energy market including for electricity and gas, with a power to direct the AEMC with respect to Rule making and market development.
- The AEMC as responsible for rule-making and energy market development at a national level, including in respect of the electricity Rules and the National Gas Rules.
- The AER as responsible for economic regulation and compliance at a national level, including in respect of the Australian Energy Market Legislation.
- A new legal framework through the National Electricity Law (NEL) – a central feature of which is the National Electricity Objective and Revenue and Pricing Principles – and the creation of 'Rules' as a statutory instrument, which can be changed expeditiously by the AEMC after undertaking an evidence-based review, subject to the requirements of the NEL.

The outcome of these reforms was a new institutional structure that was unique to Australia. In particular, the traditional 'regulatory discretion' from other regimes (i.e., the decisions that are made under broad guidance set out in the law) was split

[12] MCE, *Report to the Council of Australian Governments, Reform of Energy Markets,* 11 December 2003, p.4.

between two entities, the AEMC who exercises that discretion through making rules, and the AER who exercises that discretion through making determinations. Unlike legislation, the Rules are able to be changed expeditiously where warranted; however, by enshrining key parts of the regime or principles in the rules and then leaving those rules in the control of an entity that is separate to the economic regulator, the certainty of the regime is enhanced considerably.

Given the existence of an independent rule maker in Australia (together with the capacity for those rules to be changed expeditiously after an evidence-based review), the appropriate question is how best these arrangements can be used to promote the NEO. Asking, as the AER has done, how the breadth of the AER's discretion compares to other regulators whose role is much wider, is not, therefore, a relevant consideration in the context of rule development.

The AEMC gave substantial consideration during its last review of the revenue setting rules about the appropriate role for the rules in light of Australia's unique institutional setting. This matter is turned to below.

2.2.2 Balance between rules and AER discretion in the Australian environment

When this governance and institutional framework was implemented the AEMC was charged with developing the new Rules for the regulation of transmission services. In undertaking this task the AEMC placed considerable attention on whether it achieved the appropriate balance between prescription and discretion. In its final determination the AEMC explained its approach to prescription versus discretion in the development of the Rules:[13]

> *"The Commission notes that there is very little guidance or restriction on the decision making discretion of the AER in the current National Electricity Rules. The regulator is essentially free to decide what it considers to be the best revenue requirement with regard to the very high level principles set out in the Rules.*
>
> *While the majority of submissions to this Review process supported the continuation of the general approach to revenue cap regulation embodied in the SRP (with variations on matters of detail) there was widespread support amongst market participants for elevating to the Rules the key elements of the SRP in order to increase transparency, clarity and predictability of the regulatory decision making.*
>
> *The Commission has concluded that there is significant benefit in specifying in the Rules the methodology for the determination of revenue caps. Through this Review the Commission has therefore codified the continuation of the general building blocks approach to revenue cap regulation embodied in the ACCC's SRP. By elevating to the Rules the key elements of the SRP, the transparency, clarity, and predictability of regulatory decision making is increased thereby supporting the promotion of the NEM objective. As a result, the Revenue Rule provides a greater degree of direction and*

[13] AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, No.18,* 16 November 2006, pp.33-34.

guidance about the regulatory principles and procedures for making revenue determinations from that contained in Part B of Chapter 6 of the current Rules.

However, the Commission also recognises that having specified a methodology in Rules there are consequences from conferring on regulators either insufficient or excessive discretion in applying methodology. Insufficient specification in Rules can lead to uncertainty and inconsistency which can impact adversely on long term investment, while insufficient discretion can limit the ability of the regulator to respond flexibly to the different market and commercial circumstances of individual regulated businesses."

As noted in the quote above, the AEMC also considered that discretion was important in some instances because good economic regulation cannot be reduced entirely to a mechanical exercise. Therefore, it considered that in some instances good economic regulation incorporates options and flexibility so that outcomes can be tailored to the individual case. However, the AEMC's view was that where discretion is provided to the regulator its application of the discretion should be guided by the Rules. On this issue the AEMC stated:[14]

"In relation to these areas of regulatory discretion, the Revenue Rule also provides guidance on how the discretions are to be exercised. For instance, the approach to assessing proposed forecast operating and capital expenditure in the Revenue Rule is an example of the Rules providing appropriate decision making discretion to the regulator (given the inherent uncertainty of such forecasts) with specific guidance on how that discretion is to be exercised. In other areas where the AER is provided discretion in the exercise of its regulatory function, the Commission has sought to provide additional certainty via requirements for the regulator to consult and develop guidelines."

While recognising that there is no absolute correct balance between prescription and discretion, Grid Australia considers that the real issue of focus should be which matters should be subjected to prescription and which are better left to guided discretion. For instance, matters where prescription should be preferred include:

- Matters that are capable of general application to all service providers
- Matters that are largely settled and are unlikely to require adjustment or refinement over time
- Matters that have no, or limited, interaction with other elements of the framework, and
- Matters that do not require adjustment in light of changing market conditions or changes in the sources of information.

Conversely, less prescription may be desirable in the following circumstances:

14 Ibid, p.35.

- Matters whose application will vary between individual service providers or groups of service providers
- Matters that are still subject to some operational testing or tweaking from time-to-time as the results of their application become known
- Matters that have a number of 'moving parts' and that are influenced by decisions on other elements of the framework, and
- Matters that may require adjustment in light of changing market conditions or changing sources of information.

The Expert Panel on Energy Access Pricing gave the issue of prescription versus discretion detailed consideration. In doing so, the Expert Panel recognised that some elements of the framework are better suited to prescription while others require guided discretion. The Expert Panel also commented on the importance that prescription in Rules can have in promoting improved certainty and transparency in decision making. It also identified that the Rule making process is the appropriate forum for such issues to be addressed.[15]

> *"… the Rules should address matters that have industry wide application or effects that are likely to change relatively infrequently over time and that do not rely on an assessment of individual market participant conditions or circumstances. These matters are more appropriately dealt with by regulatory discretion. In terms of the level of discretion given to the regulator through Rules, this raises a number of conflicting objectives, particularly from the viewpoint of regulated entities. Prescription in the Rules promotes certainty and stability of regulatory outcomes. It also assists in promoting a transparent commercial and policy assessment of the regulatory approach, given the nature of the Rule making process that now applies under the NEL and that is to be included in the NGL. Conversely, a high level of prescription reduces the regulator's ability to accommodate the particular circumstances of individual market participants in regulatory decisions.*
>
> *The balance between these conflicting objectives will vary depending on the matter at issue, as will the interests of different stakeholders. The issue may range from highly contentious financial and commercial matters, such as the method for setting the various parameters required in determining an allowance rate of return, to more mundane but nevertheless important procedural issues such as time-lines for decision making.*
>
> *Ultimately, these are all questions of detailed regulatory design. The Panel considers that the right forum for addressing them (and balancing the competing objectives outlined above) is in the Rule making process itself, which facilitates a full and transparent exchange of views and an approach tailored to meet the particular characteristics of each regulatory design issue. The Panel does not consider that any*

[15] Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy,* April 2006, p.26.

> *meaningful general principle providing guidance on the appropriate level of prescription in the Rules can or should be expressed in Law."*

The Expert Panel also commented on the importance of discretion for regulators to be appropriately guided:[16]

> *"There is, of course, a significant degree of discretion to be applied by the AEMC in the way in which those principles are reflected in the Rules. Once made, the AER's role is primarily to act in accordance with the procedures and to apply the criteria or decision making tests specified in the Rules, rather than to directly apply the statutory principles under which the Rules are made. There is potential for uncertainty and inconsistency to arise if the AER, in carrying out its regulatory functions under the Rules, is required in doing so directly to give effect to high level statutory principles. At the extreme, this creates the prospect of the AER interpreting the principles in a way that is at variance with the way the AEMC has interpreted and given more detailed expression to them in the Rules. To have two administrative bodies separately but directly accountable to give effect to the same set of statutory principles is poor regulatory design.*
>
> *Having said this, depending on the level of prescription in the Rules, there will remain a greater or lesser degree of discretion to be exercised by the AER in applying the Rules. There may also be areas of ambiguity in the way in which the Rules are to be applied in particular market or participant conditions. In those circumstances it is appropriate and desirable for the AER to be guided by the high level statutory principles in interpreting and applying the Rules. For that reason, the Panel recommends that direction to the AER as to the manner in which it performs its regulatory functions should be derived primarily from the overriding objective and the Rules. To the extent that the Rules provide discretion to the AER or allow for alternative interpretations in their application, the AER should be guided by the same statutory principles that applied to the AEMC in making the relevant Rules."*

2.3 AEMC has proposed a sound framework for assessing the Rule change

- Grid Australia welcomes the AEMC's proposed framework for assessing the AER Proposed Rule Changes. Assessing the proposal against the four questions will encourage an evidence based assessment of the scheme.
  - A high level test of the AER proposal against these four questions demonstrates deficiencies in the AER's key proposals.

Grid Australia notes that the AEMC has approached the review of the AER's rule change proposals by asking four key questions, which in broad terms are:

- Whether participants agree with the nature of the problem

[16] Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy,* April 2006, p.28.

- Whether the AER proposal achieves the right balance between prescription and discretion

- Whether the AER could already achieve the outcome sought through use of its existing discretions, and

- Whether the solution the AER has proposed is the preferred solution, or whether more preferable solutions exist.

Grid Australia welcomes the Commission's proposed approach and considers that such a framework will focus participants on ensuring there is a sound evidence-based assessment of the Proposed Rule Changes against the NEO and Revenue and Pricing Principles. Accordingly, we have structured our comments on the Proposed Rule Changes to address these four questions.

We note at the outset that a high level assessment of many of the elements of the AER rule change proposal brings to light deficiencies in the proposal. For example:

- *The problem* – the problems that the AER assert to exist with the current framework for assessing expenditure forecasts are not supported by an analysis of the reviews the AER has undertaken under the new rules. That is, the AER has not found itself to be constrained from undertaking whatever analysis it considered appropriate. It has rejected forecasts it found to be inappropriate and there is no evidence to indicate that it has adopted substitute values that are higher than it would have preferred. The one constraint that exists under the new rules for transmission is that the review commences with the TNSP's proposal and that the assessment be based on evidence, which Grid Australia submits is highly appropriate and should be retained.[17]

- *Prescription and discretion* – the majority of the AER's Rule changes seek substantial additional discretion (and a reduction in the guidance over the exercise of that discretion), which Grid Australia submits is inconsistent with the allocation of responsibilities between the AEMC and the AER and will not meet the NEO. In contrast, however, the AER also proposes to 'hard-wire' a new capital expenditure incentive scheme into the Rules, notwithstanding the complexity of such schemes and the need for elements to be tailored to the circumstances of sectors and possibly also individual businesses.

- *Use of the AER's existing discretion* – at least with respect to distribution, the AER is already able to introduce an efficiency benefit sharing scheme for capital expenditure, and so address the incentive issues that it has identified; however,

[17] A key factor in requiring the AER to commence with a TNSPs Revenue Proposal was the AEMC's explicit requirement for TNSPs to provide fully supported Revenue Proposals. This was partly to balance information asymmetry concerns (see AEMC Rule Proposal Report, February 2006, pp.39-40) and to allow the regulator to make better informed decisions regarding the efficient cost of providing transmission services (see AEMC Draft Determination, July 2006, p.111).

the AER has as yet chosen not to do so.[18] As noted above, the AER is already able to undertake whatever analysis it sees fit when assessing a TNSP's expenditure forecast, and to adjust those forecasts where warranted by the evidence.

- *The solution* – Grid Australia accepts that changes to the Rules are warranted in certain areas, including to broaden the evidence that may be used to inform the allowance for the cost of debt in the WACC (as described further in section 5) and to consider enhancements to the capital expenditure incentives (as described further in section 4). However, in relation to the former, the AER's proposal would strip away all guidance on this important matter, which is an unnecessary and inappropriate broadening of the AER's discretion. With respect to the capital expenditure incentive scheme, Grid Australia supports consideration of a scheme that meets best practice design principles, including to treat gains and losses symmetrically and to recognise the situation of the different sectors and regulated businesses and factor that into the design of the scheme.

[18] As discussed further below, the AER's proposed capital expenditure incentive scheme could be expressed in terms of an efficiency benefit sharing scheme, but would not meet the criteria for an efficiency benefit sharing scheme. This is because the AER's scheme has an asymmetric effect and does not create a continuous incentive.

3. Capital and Operating Expenditure Forecasts

Setting an appropriate forecast for expenditure over the regulatory period is essential to providing businesses with the capacity and incentive to provide the services sought by customers over the long term, while providing an efficient price for customers. This section addresses the AER's specific proposals relating to capital and operating expenditure forecasts, specifically:

- The setting of estimates of required expenditure, and
- The objectives, factors and criteria that the AER is required to consider when assessing expenditure forecasts.

3.1 Setting estimates of required expenditure

3.1.1 Overview of Grid Australia position

- The AER has not provided any evidence of a problem:
  - The AER's decisions under the transmission Rules to date suggest that the AER has the power to undertake whatever assessment it considers necessary to properly assess forecasts and to undertake whatever modification is required to ensure compliance with the Rules.
  - There is no evidence from the AER's decisions that it has been constrained to revise forecasts only to the top of a range, nor a limitation (apart from the requirement to make an evidence-based decision) on the scope to applying benchmarking or other analytical techniques.
  - There is no specific 'burden of proof' on either a network business or the AER. Instead, the framework creates a practical hurdle for a network business to provide sufficient evidence in support of its expenditure forecast to satisfy the AER, and a requirement for the AER to provide evidence where it is not satisfied on the efficiency and prudency of the expenditure forecast.
- Accepting the AER's proposed Rule change will remove a number of important features of the existing framework, in particular, the incentive to submit fully articulated proposals, and a requirement for the AER's decisions to be based on evidence. These outcomes are achieved under the current framework by:
  - Requiring the key assumptions of the revenue proposal to be signed off by the directors of the transmission business

- Requiring the AER to place the proposal at the centre of its analysis and to provide evidence and reasons as to whether it is, or is not, satisfied the proposal reasonably reflects the expenditure criteria, and
- Allowing the AER, if it is not satisfied that the total forecast amounts reasonably reflect the expenditure criteria, to substitute the proposal with its own forecast.

- Grid Australia also notes that the AER's preference to focus on achieving a 'best estimate' further reduces the status of a revenue proposal as a basis for the AER's evidence and ignores the practical limitations to determining such an amount.

3.1.2 What has the AER proposed and why?

The AER has proposed that it simply be required to 'determine' what it considers is the efficient level of expenditure for a network business. This, therefore, removes the requirement for the AER to have regard to the existing expenditure criteria in the Rules when assessing expenditure forecasts.

The AER has made this proposal on the basis that it considers the current framework allows network businesses to propose the highest possible forecast and excludes the AER from setting a lower forecast that is efficient, prudent and realistic. The AER has also stated that as proposals are based on a large amount of engineering detail that it must conduct a line-by-line analysis of proposals to the exclusion of 'top down' techniques like benchmarking.[19]

Grid Australia notes that the AER has indicated that the issue is most relevant for distribution networks on the basis of further restrictions on its discretion contained in chapter 6 of the Rules.

3.1.3 Is there a problem that needs to be addressed?

While recognising that the AER's primary concern appears to be with the distribution framework, Grid Australia does not consider the AER has identified that there is a problem with the expenditure forecasting framework nor that the AER is precluded from doing the analysis it seeks.

Contrary to the AER's views, Grid Australia considers that the expenditure forecasting framework has operated as intended by the AEMC when the Rules were developed. The framework has provided an incentive for businesses to submit well articulated and robust forecasts and has similarly required the AER to undertake a robust, evidence-based assessment of the forecasts against relevant criteria.

[19] AER Rule Change Proposal, p.13

Appendix B of the Joint Expert Report on expenditure forecasts provides a comprehensive examination of the analysis undertaken by the AER when assessing expenditure forecasts. This examination supports Grid Australia's contention that the AER has not provided any evidence that the forecasts that it has approved to date have been inefficient, or that the Rules have prevented it from rejecting inefficient forecasts. Instead, the evidence indicates that:

- the AER has routinely rejected forecast operating and capital expenditure allowances
- the AER has made statements affirming the need for increased expenditure at the time of determinations
- the AER has not stated in its determinations that the Rules have limited its ability to reject forecasts, and
- the AER has not provided a discussion of ranges in any of its determinations.

The AER has made substantial cuts to revenue proposals and endorsed the forecasts made in final determinations

When the evidence is analysed it shows that the AER has not been restricted in its ability to reject forecasts put forward by the business. The table below identifies that for every transmission business in the NEM that has had a determination under the existing framework; the AER has made cuts to the proposed forecast expenditure. Indeed, comparisons between the previous and current regulatory frameworks indicate that the AER has not been any more constrained in its ability to reject forecasts under the current construction of the Rules compared to the previous framework.

Table 1: Headline Difference between Initial Revenue Proposals and AER Final Determinations[20]

Company	Current Framework		Previous Framework	
	Capital Expenditure	Operating Expenditure	Capital Expenditure	Operating Expenditure
Transend	-11%	-9%	-7.3%	-16.6%
TransGrid	-6%	-11%	-15.9%	-10.6%
ElectraNet	-17%	-8%	-4.2%	-33.6%
SP AusNet	-10%	-5%	+2.4%	-1.8%
Powerlink[21]	-32%	-8.2%	+3.8%	+4.5%

[20] Grid Australia notes that, particularly for the current framework, some of the differences between proposed expenditure and the AER's final determination may result from projects being shifted from the general revenue cap into the contingent projects mechanism. In addition, some of the differences may also reflect a shifting of expenditure between capital and operating expenditure.

Source: AER and ACCC transmission revenue determinations

These cuts to expenditure made by the AER demonstrate that where it considers that proposed expenditure forecasts do not meet the expenditure criteria in the Rules, it has rejected amounts and substitute forecasts as necessary. At no time has the AER indicated that it would have preferred to make larger reductions from proposed forecasts but was prevented in doing so by the Rules framework. In actual fact, statements made by the AER at the time of determinations indicate that any increases in forecast expenditures over previous actual expenditures were necessary and efficient. For instance with respect to the ElectraNet decision the AER stated:[22]

> *"While South Australian consumers will face higher charges as a result of the decision, they will also benefit from a more reliable network."*
>
> *Further, given the scope of new infrastructure that is proposed for South Australia over the coming years, the investment by ElectraNet over the next regulatory control period should ensure the electricity network is well placed to meet the potential increase in demand without jeopardising reliability."*

For TransGrid in NSW the AER stated:[23]

> *"Despite the revised economic outlook, there remains a need to build new network capability to meet future customer demand in NSW. As a result, transmission charges in NSW are still forecast to rise during the next five year period, albeit more moderately than previously expected."*

and:

> *"The capital allowance will allow TransGrid to undertake a number of important network projects including commencing construction of a 500 kV network around the Newcastle – Sydney – Wollongong area to meet future load growth, as well as reinforcement of the inner Sydney 330 kV system to improve reliability."*

For the Transend network the AER stated:[24]

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21 In the case of Powerlink the current framework amounts refer to its recent draft decision and not a final decision. The numbers provided under the previous framework for Powerlink reflect its 2001 decision given the 2007 Powerlink decision was undertaken under transitional arrangements. It is relevant to note that the increases in approved capital expenditure in the previous framework reflect differences in interest during construction and for operating expenditure, efficiency gains associated with the Queensland and New South Wales Interconnector (QNI).

22 http://www.aer.gov.au/content/index.phtml/itemId/719089

23 http://www.aer.gov.au/content/index.phtml/itemId/728139/fromItemId/746345

24 http://www.aer.gov.au/content/index.phtml/itemId/728141/fromItemId/746345

> *"This increase primarily reflects the need for Transend to augment its network to meet new network performance and security requirements and replace aging assets"*

The AER went onto say:

> *"This decision will fund a comprehensive program of major projects such as:*
>
> - *Transend's asset renewal program - $ 200 million*
> - *Waddamana-Lindisfarne transmission line and substation - $120 million*
> - *Norwood-Mowbray transmission line - $28.6 million*
> - *George Town substation security upgrade - $18.3 million*
> - *and all of Aurora's new connection point requests"*

In its press release upon the publication of the SP AusNet decision the AER stated:[25]

> *"The AER's decision allows for an increased level of investment which is necessary to provide for the efficient replacement and repair of aging assets in the Victorian transmission network over the forthcoming period to maintain reliability and security of supply"*

In addition to the statements above made by the AER, as identified in Appendix B of the Joint Experts Report on expenditure forecasts, the only statement the AER has made in any of its transmission determinations that implied the AER did not make the full adjustment to forecasts it considered appropriate was in its most recent draft decision for Powerlink (which was released after the AER's Rule Change Proposal).

However, in this draft determination, the AER has made conflicting statements, simultaneously claiming to have adjusted the expenditure forecast only to the minimum extent necessary to meet the Rules criteria while also stating it has substituted Powerlink's forecast with its own. The AER states in the draft decision for the Powerlink revenue determination that:[26]

> *"This attachment outlines the AER's draft decision, its reasoning and its approach to assessing the reasonableness of Powerlink's proposed capex forecasts and the substitute forecast. The substitute forecast is the minimum adjustment necessary for Powerlink to meet the National Electricity Rules (NER) criteria."*

However, the AER has also indicated in the Powerlink draft decision that it has replaced Powerlink's forecast with its own:[27]

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[25] See: http://www.aer.gov.au/content/index.phtml/itemId/717348/fromItemId/746345

[26] AER, *Draft Decision, Powerlink Transmission determination, 2012-13 to 2016to17,* November 2011, p.97

[27] AER, *Draft Decision, Powerlink Transmission Determination, 2012-13 to 2016-17,* November 2011, p.xi

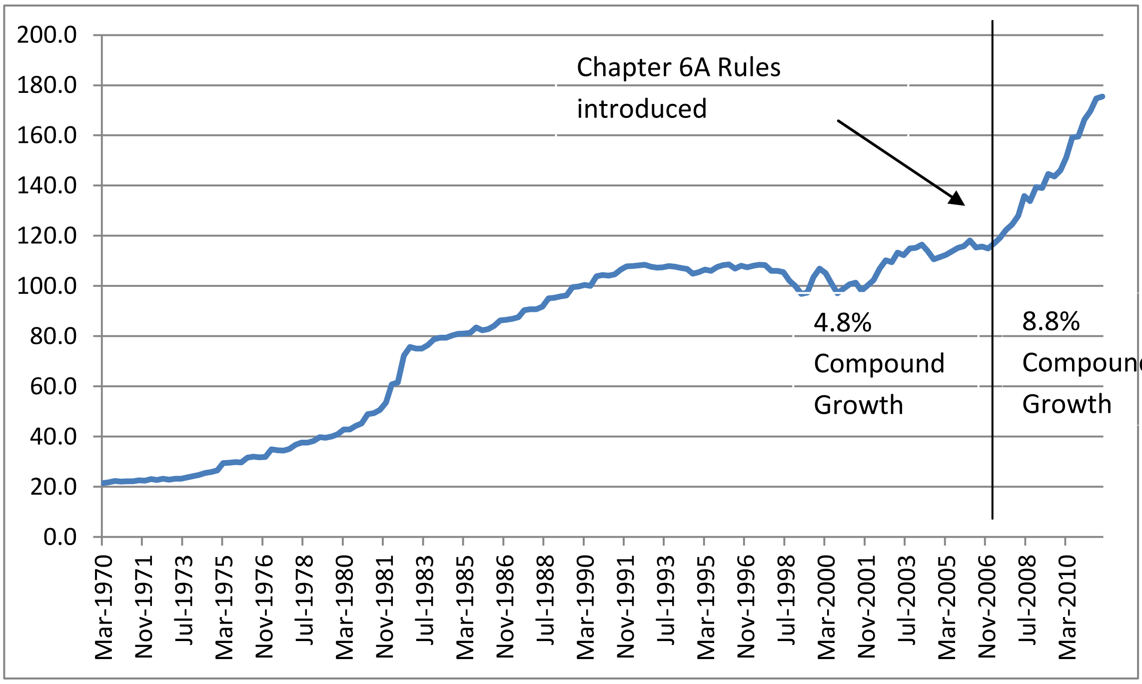
> *"The AER considers Powerlink's proposed total forecast capex is more than is necessary to achieve the capex objectives in the NER. The AER has substituted Powerlink's total forecast capex with its own forecast. The key reasons for this are rejection of the costs associated with the proposed 500kV upgrade and lower demand forecasts, which reduce load driven capex. If the AER was to accept Powerlink's capex, the draft decision would have resulted in total (unsmoothed) revenue increasing by a further $254.8 million ($nominal) over the next regulatory control period."*

It is surprising, therefore, that the AER claims that it is required to accept forecasts at the top end of a range but has only once made reference to this range or where a forecast may sit within it. In the one circumstance where the AER did indicate that it adjusted the forecast to an implied top of a range, this conclusion was not consistent with the analysis that underpinned the AER's draft decision. Grid Australia also notes that in every transmission determination the AER has undertaken an assessment of the reasonableness of *total* expenditure. Again, as noted in chapter 3 of the Joint Experts Report on expenditure forecasts, should the AER not be satisfied that total expenditure reasonably reflects the expenditure criteria, there is no restriction which prevents the AER substituting its own forecast. Given this evidence, it is not clear to Grid Australia where the AER's concerns actually lie.

Revenue determinations have been made at a time of increasing input costs

The increases that were approved by the AER also occurred at a time when the cost inputs into electricity networks increased significantly over the period. Therefore, the analysis undertaken by the AER fails to take into account any real world factors that influence investment costs. The figure below taken from ABS data shows the impact of the mining boom on the input costs for the electricity sector, in turn causing input prices to rise significantly since the time the new framework was introduced into Australia.

Figure 3: Producer Price Index - Materials Used in Manufacturing Electricity



Source: ABS Time Series 6427.0, Tables 12 and 13.

The AER has predominately undertaken the same analysis as it did under the previous framework

The AER has expressed concern that the current construction of the Rules limits the types of analysis it is able to apply when assessing expenditure forecasts. However, when the approach taken by the AER/ACCC under the previous DSORP/SORP framework and the current framework is compared, it is evident that it has applied a virtually identical process and methodology to assessing forecasts. Grid Australia considers the AER's actions to date supports the contention that the current Rules have not constrained the AER's approach to its assessment of expenditure forecasts and it is able to undertake all and any analysis it wishes to do.

For Powerlink, the AER's current review and the review under the SORP for capital expenditure comprised the following key elements:

- *Governance framework* – under both frameworks the AER has undertaken a review of the policies and procedures of the businesses for identifying capital expenditure requirements.

- *Probabilistic planning approach* – the AER analysis has focused on the reasonableness of scenarios and the planning process applied.

- *Demand forecasting* – under both regimes the AER has investigated the validity of the forecasting assumptions, inputs and methods applied and the approach to aspects such as determining maximum demand and temperature corrections.

- *Detailed review of selected projects* – under the previous framework and the current framework the AER has requested its consultants undertake a detailed review of a sample of projects. In both cases consultants have been asked to address questions such as the need for investment, other options, and the general prudence and efficiency of the projects.

- *Cost accumulation process* – the AER has applied a consistent approach to its assessment of the estimation of the cost and profile of capital expenditure over a regulatory period. Specifically it has reviewed unit costs, escalators, cost estimation risk factors, s-curves and benchmark costs.

- *Deliverability* – under each framework the AER has undertaken a review of the deliverability of the proposed capital expenditure program.

3.1.4 Does the proposal put the right balance on prescription and discretion?

The existing framework achieves the right balance between prescription and discretion

There are a number of key features in the current framework that in combination provide the appropriate balance between prescription and discretion when setting expenditure forecasts. These features include:

- the status given to the business's expenditure forecast in the assessment framework

- the capacity for the AER to reject a forecast and substitute it with its own, and

- guidance in the Rules that directs the AER's consideration of a forecast to be based on evidence.

Under the existing framework the AER is first required to consider whether the transmission business' proposed expenditure forecast meets the criteria set out in the Rules. More specifically, the AER is required to consider whether it is satisfied that the total forecast amounts reasonably reflect the expenditure criteria, taking into account the expenditure factors.

When asking itself whether it is satisfied that the proposal put forward by the business reasonably reflects the expenditure criteria, the AER is not restricted in the tests it can apply and the analysis it undertakes. The restriction on the AER is that it provides reasons as to why it is either satisfied or not satisfied that a proposal reasonably reflects the expenditure criteria in the Rules, and that this decision is based on evidence. This fact was emphasised by the AEMC when developing the chapter 6A Rules:[28]

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

Statements made by the AER when making its determination confirm that the AER has applied the Rules as intended by the AEMC. Specifically, in relation to TransGrid's final determination the AER stated:[29]

> *"As the AER is not satisfied that TransGrid's forecast capex reasonably reflects the capex criteria, under clause 6A.6.7(d) of the NER, the AER must not accept the forecast capex in TransGrid's revised revenue proposal. Instead, the AER is required under clause 6A.14.1(2)(ii) of the NER to provide an estimate of the total capex that TransGrid will require over the next regulatory control period that the AER is satisfied reasonably reflects the capex criteria, taking into account the capex factors.*
>
> *Based on its own analysis and the advice of PB, the AER has reduced TransGrid's revised capex proposal by $110 million. This represents a reduction of around 4.4 per cent to TransGrid's revised forecast capex."*

The framework implemented by the AEMC presents two key benefits:

1. it provides an incentive for businesses to submit well articulated and soundly based forecasts, and

2. it provides certainty and predictability regarding the requirements that need to be satisfied for an expenditure forecast to be accepted by the AER.

The expenditure forecasting framework in the Rules provides a strong incentive for transmission businesses to submit well articulated and soundly based forecasts of their capital and operating expenditure requirements. This outcome is achieved by:

- Requiring that the key assumptions of the revenue proposal be signed off by the directors of the transmission business[30]

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[28] AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, No.18,* 16 November 2006*,* p.53.

[29] AER, *Final Decision, TransGrid transmission determination, 2009-10 to 2013-14,* 28 April 2009, P.44

- Requiring that the AER's assessment be focused upon the proposal submitted by the business, and

- Allowing the AER, if it is not satisfied that the total forecast amounts proposed by the business reasonably reflect the expenditure criteria, taking into account the expenditure factors, to substitute the proposal with an amount that it considers to reasonably reflect the expenditure criteria.

Under this framework, if a business put forward an ambit claim, the AER would effectively be at large to substitute the forecast with its own potentially materially lower forecast as long as it complied with the expenditure criteria.

The effectiveness of the incentive to submit a well-articulated and soundly based forecast is further enhanced for future regulatory periods. One of the factors that the AER is to have regard to when assessing a revenue proposal is the actual and expected capital expenditure during any preceding regulatory control period.[31] This requirement means that the AER will have regard to revealed costs and the implications of deviations from previous forecasts when assessing future expenditure forecasts. In addition, lessons taken from appeal decisions will also assist in improving the relevance of material provided in revenue proposals and therefore the robustness of outcomes.

The requirement for the AER to place the proposal at the centre of its analysis and to provide evidence and reasons as to why it is, or is not, satisfied provides certainty and predictability to the businesses. This is because the businesses are aware that if they are able to satisfy the AER that their expenditure forecasts are required and efficient then the AER is required to accept these forecasts, and hence precludes it from making further adjustments that are not based on evidence.

The AEMC's remarks when developing the Rules confirm its intention for the framework to provide an incentive for well-articulated, evidence based, proposals from the business, and a requirement for evidence based decision making from the regulator:[32]

> *"In formulating the Revenue Rule the Commission has been assisted by the advice of Mr Neil Williams SC and Dr Ruth Higgins in relation to the decision-making rule and criteria adopted in the Draft Rule. The Commission has not thought it appropriate for*

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31 Clause 6A.6.7(e)(5) of the NER

32 AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, No.18,* 16 November 2006, p.56

the Rule to impose a legal burden of proof in the manner that is commonly understood. The advice of Williams SC and Higgins makes it clear that no "burden of proof" arises. Of course the TNSP faces a practical hurdle that if it fails to provide sufficient information to enable the AER to be "satisfied" as to whether the proposal meets the decision rules its proposal will be rejected.

Further, the Commission did not think it appropriate to adopt a decision rule which required the AER to conclude that the TNSP's proposal was "unreasonable" before it could reject it. Again the Commission has been assisted by advice of Williams SC and Higgins which states that this is not the case. Rather, the decision rule operates to require the AER to reject the TNSP's proposal if it is not satisfied that it meets the criteria specified."

The AER proposal does not achieve the right balance between prescription and discretion

The AER's proposal is that it determine its preferred, or 'best estimate', rather than to first assess the reasonableness of the network business' proposal. The implication of this is that no evidence or reasons would be required to dismiss the proposal, other than what is necessary to satisfy due process requirements.

Stephen Gageler SC, in providing advice for the transmission businesses during the formation of the current Rules, commented on the application of a best estimate test. Gageler observed that applying a best estimate test would effectively lead to a proposal only being accepted when the forecast provided by the business precisely matched the regulators view.[33]

"The AER would no longer be asking whether the forecast proffered was the product of sound judgement but whether it was the product of a right judgement in the sense of it being a judgement that coincided precisely with its own.

In effect, the AER would be empowered to simply make its own estimate."

Grid Australia's concern is that the additional discretion the AER seeks will in fact merely reduce the analytical and evidentiary threshold for the AER, thus heightening regulatory risk. Grid Australia is particularly concerned that in striving for a level of precision that is unattainable the AER inevitably will avoid placing proper weight upon important pieces of evidence and place undue weight upon less reliable sources of information.

The AER's proposal would, if accepted, undo the two important benefits of the existing regime identified in the previous section.

- Under the AER's proposed construction of the Rules there would be no incentive for the network business to provide a well articulated and robust

[33] Stephen Gageler SC, *In the Matter of the Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Opinion*, 25 October 2006, paragraphs 31 and 32.

proposal. The AER's proposal would require it to 'determine' the forecast of required capital expenditure for a transmission business that it considers would meet the efficient costs that a prudent transmission business would require to achieve the expenditure objectives. Therefore, the business' revenue proposal would be consigned the value of another submission in the process. This is because the AER would no longer make a decision on whether to accept or reject the proposal. As a consequence, the AER would also no longer be required to provide evidence and reasons as to whether it is satisfied or not having regard to the business' proposal.

- By proposing to give itself increased discretion in the determination of forecast expenditure, the AER has also increased the risk faced by businesses. That is, the proposal would remove the confidence for the businesses that satisfying the AER that forecast expenditure is required and efficient will be sufficient for it to accept the forecast. The prospect of the AER determining an amount significantly less than an otherwise compliant proposal risks constraining the ability of network businesses to efficiently meet their regulatory obligations and reliability standards. The corollary of the introduction of this risk is a blurring of the lines of accountability between the AER and the businesses for service delivery.

Grid Australia also notes that while the AER seeks to increase its discretion to determine forecast expenditure on the one hand, it has explicitly indentified that accountability for delivering prescribed transmission services lies squarely with the transmission businesses.[34]

Lastly, we note that much of the discussion in the AER's proposal is focused on its need to be free to determine the 'best' forecast. However, this focus on striving for a 'best' forecast ignores the dominant view of expert commentators such as the AEMC and the courts that there is no 'best' forecast, there is only evidence. On this matter the AEMC stated the following when developing the current Rules:

> *"The Commission believes that the subject of the regulation – the forecast capital expenditure and operating expenditure for substantial, highly complex and technical infrastructure for a five-year period is not a matter that is amendable to the level of precision and confidence that would enable one to sensible say there is one correct or "best" figure. It considers that Rules that could be interpreted in that way are likely to result in a heighted risk of regulatory error. Equally the Commission does not intend that the Rules contemplate such a range of permissible outcomes that there is a risk of inherent bias towards higher amounts."*

[34] For example, AER, *Draft Decision, Powerlink Transmission determination,2012-12 to 2016-17*, November 2011, p.xi.

3.1.5 Could existing discretions achieve the same outcomes?

Grid Australia considers that under the transmission Rules the AER does already have the discretion that it is seeking to achieve in its Rule proposal, in particular, the discretion to substitute an expenditure forecast with its own when it is not satisfied. Such a position was clearly articulated by former AEMC Commissioner, Liza Carver, at the recent AEMC Public Forum on 23 November 2011. In addition, the AER has not been limited in the analysis it can apply when making a determination.

As indicated in the previous section, and further elaborated in chapter 3 of the Joint Experts Report on expenditure forecasts, if the AER is not satisfied that the total of an expenditure forecast in a transmission business' revenue proposal reflects the operating expenditure criteria then it must reject the proposal and subsequently substitute the forecast with an amount it considers satisfies the operating expenditure criteria. This means the AER is not limited to a line-by-line assessment and is able to base its assessment on the total of the forecast expenditure. Therefore, the AER is provided with the ability to examine forecasts as it sees fit and to reject them when it is not satisfied that they meet the requirements of the Rules.

The only constraint on the AER when it assesses forecast expenditure is that it provides reasons for its decision based on the business' proposal. Grid Australia considers that constraining the AER's ability to reject in accordance with criteria and factors in the Rules in this way is entirely appropriate. This is because it reduces the scope for the AER to make an arbitrary determination, and also provides increased confidence that the amount that is ultimately accepted by the AER is sufficient for transmission businesses to undertake their required functions and obligations, that is, to deliver the services for which they are accountable.

3.1.6 The preferred solution

As noted above, Grid Australia does not consider that the Rules for transmission businesses limit the AER's scope to substitute a proposal that does not meet the requirements in the Rules with one that it considers does meet those requirements. In addition, Grid Australia considers that the benefits of the existing framework, such as the incentive to provide a well-articulated proposal, would be lost if the AER's solution was made into Rules. Therefore, Grid Australia strongly advocates that the NEO and the Revenue and Pricing Principles would not be promoted by a change in the expenditure forecast framework for transmission.

3.2 Expenditure objectives, factors and criteria

3.2.1 Overview of Grid Australia position

- Grid Australia agrees that the combination of evidentiary and process factors may create ambiguity and that refinement would be beneficial
- The requirement to have regard to the 'individual circumstances of businesses' should not be completely removed from the Rules. However, it is appropriate that any undue restriction on proper benchmarking of expenditure forecasts should be removed:
  - for example, the Rules could clarify that the consideration of individual circumstances extends to the exogenous factors that affect expenditure requirements (like service obligations and geography) and to the starting position of TNSPs at the time that expenditure forecasts are made, but not to factors that are internal to the businesses (such as gearing levels, levels of efficiency, etc.).

3.2.2 What has the AER proposed and why?

The AER has proposed a number of changes to the construction of the expenditure objectives, factors and criteria:[35]

- The expenditure criteria should be removed – including the requirement to have regard to the individual circumstances of the relevant NSP
- There should be a clearer separation between procedural and evidentiary expenditure factors
- Some factors should be re-drafted to clarify their intent
- A new factor should be included that allows the AER to have regard to any other relevant factors

The AER argues that the expenditure criteria are no longer required in a circumstance where it determines forecast expenditure. In doing so, the AER has proposed to delete the criteria relating to the circumstances of the relevant network business. The AER's rationale is that this requirement potentially limited its application of benchmarking to forecast expenditure.

The AER also noted that the factors contain both process and evidentiary aspects which cause ambiguity.[36] Specifically, the AER notes that:

35 AER Rule Change Proposal, p.36

- The first three expenditure factors are procedural and do not substantively add to an assessment against the expenditure criteria
- The Rules should clarify that the list of factors is not exhaustive
- The level of specificity for expenditure factor eight is unwarranted and potentially removes the flexibility of the regulator to consider all expenditure, including labour cost levels (past and forecast) relative to service standard targets and or other incentive schemes.

3.2.3 Is there a problem that needs to be addressed?

Grid Australia agrees with some aspects of the AER's proposed changes in this area. Specifically, Grid Australia agrees that the combination of process and evidentiary aspects of the factors may cause ambiguity. For the reasons articulated by the AER, on these specific proposals, Grid Australia supports the AER's proposed changes.

However, Grid Australia does not consider that the AER has properly characterised the problem regarding the requirement to have regard to the 'individual circumstances of a business' and its impact on benchmarking. Grid Australia acknowledges that when used properly, benchmarking may be effective as a comparative tool to draw inferences about the efficiency of proposed expenditure levels from observed outcomes for similar businesses. Grid Australia also agrees that it is not appropriate for benchmarking to have regard to internal circumstances of a business.

For instance, it would not be appropriate to consider the effect of previous managerial decisions on the capacity for a business to raise capital. However, benchmarking, when properly applied, should have regard to the starting base for businesses and to the exogenous factors that may impact differently across businesses. These include factors such as customer density, local topography and the network that is in place at the time that expenditure forecasts are made (including the age of relevant assets). If benchmarking did not have regard to these factors it would pose an unacceptable risk that a business may not be able to earn sufficient revenue to meet its costs. Therefore, while Grid Australia agrees that the requirement to have regard to the individual circumstances of the business may limit the AER's ability to apply benchmarking properly, the extent to which this is a problem depends on how broad an interpretation is taken of the 'individual circumstances of a business'.

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[36] AER Rule Change Proposal, pp.33-34

3.2.4 Does the proposal put the right balance on prescription and discretion?

Grid Australia considers that removing the requirement for the AER to have regard to the individual circumstances of the business does not provide the right balance between prescription and discretion. This is because it removes an important consideration that should be taken into account when setting forward looking costs for an individual business.

As indicated above, when setting expenditure requirements, as well as when undertaking benchmarking, it is appropriate for the regulator to take into account variations between forward looking expenditure requirements between individual businesses. However, the AER's proposal does not strike the right balance between prescription and discretion because it removes entirely the requirement for the AER to have regard to individual characteristics that should be applied in benchmarking and which influence forward looking costs.

3.2.5 Could existing discretions achieve the same outcomes?

Grid Australia considers that the ability for the AER to perform benchmarking appropriately under the existing framework is largely a matter of interpretation of the existing Rules. As previously mentioned, a broad interpretation of the individual circumstances of a business may direct the AER to consider factors that should not be incorporated into a benchmarking assessment.

3.2.6 The preferred solution

While Grid Australia accepts the AER's proposed solution with respect to the clarification and tidy-up of process and evidentiary factors in the Rules, it does not agree that the AER should not be required to have regard to individual characteristics of a business that influence future costs. On that basis, Grid Australia recommends that the Rules are clarified so that the AER is required to only have regard to the starting position of TNSPs at the time that expenditure forecasts are made and to relevant exogenous factors that influence the forward-looking operation of a TNSP's business.

4. Incentive arrangements

Grid Australia considers that a combination of sustainable commercial incentives and well-focused regulatory obligations are the best means of promoting outcomes that are consistent with the NEO. In particular, where practicable, well designed incentive based arrangements will lead to better outcomes than would be achieved by direct regulatory intervention. This is because incentive arrangements provide businesses with the opportunity and incentive to find ways of meeting the desired objective through lower cost means, or to provide superior outcomes at the same cost, including by taking account of new information as it becomes available.

Grid Australia notes that the AEMC has identified the importance of incentives for transmission networks as part of the Transmission Frameworks Review. The AEMC has stated that its objective for transmission frameworks is to incentivise investment and operational decisions across transmission and distribution to minimise the total system costs faced by consumers. The AEMC has identified that for transmission this implies:[37]

> *"TNSPs have incentives to:*
>
> - *Operate efficiently, so as to maximise network availability in the short run; and*
> - *Invest efficiently, such that load requirements can be met at least cost while maintaining quality, safety, reliability and security of supply;.."*

The remainder of this section addresses the AER's specific proposals for the incentives framework, specifically:

- The incentives to minimise capital expenditure
- The scope for broad discretion to implement other incentive schemes, and
- The application of actual or forecast depreciation.

[37] AEMC, *Transmission Frameworks Review, First Interim Report,* 17 November 2011, p.17.

4.1 Capital expenditure incentives

4.1.1 Overview of Grid Australia position

- Grid Australia acknowledges that there are shortcomings with the current incentive arrangements for capital expenditure and that it is appropriate to explore refinements although it notes there is no evidence that actual expenditures are higher than efficient levels.
  - Regulatory obligations, such as the RIT-T, combine with incentives and provide a limit on the capacity for TNSPs to undertake projects that are not justifiable in terms of the NEO
- However, the incentive arrangement proposed by the AER has a number of flaws, namely:
  - the incentive power of the scheme is uncertain (as it varies according to whether an NSP expects to spend more than the regulatory allowance); however, for an entity that does expect to spend more than the allowance, the penalties for undertaking capital projects would be increased substantially and encourage an inefficient substitution towards operating expenditure and discourage TNSPs from undertaking 'market benefit' projects
  - the scheme is asymmetric and so does not encourage underspending TNSPs from continuing to pursue efficiency gains at the end of the regulatory period and is also inconsistent with the revenue and pricing principles,
  - the asymmetric penalty on overspending may also lead to TNSPs inefficiently deferring, or avoiding, otherwise efficient and required investment on the network, and
  - it does not provide a continuous incentive across regulatory years
- In addition, in seeking to codify the operational detail of the scheme in the Rules and to pursue a 'one-size-fits-all' approach the AER has failed to consider many of the complex matters that need to be addressed, namely:
  - the need to make an informed decision about the incentive rate of the scheme, addressing matters that are unique to transmission – such as differences in the types of projects and service incentives/ obligations, and
  - the need to consider measures to ameliorate the risk caused by the scheme, again paying explicit attention to the matters that are unique to transmission.
- Grid Australia notes that the AER already has the ability to introduce a capital

expenditure efficiency benefit sharing scheme for distribution, and considers that the extension of the same capacity for transmission should be explored. However, prior to doing so, Grid Australia considers there should be a review of the current criteria to ensure that the AER is guided to all of the matters that are relevant to the application of such a scheme to transmission

– It is noted here that the current criteria for an efficiency benefit sharing scheme omit a requirement to consider 'risk' as well as the effect of other incentive schemes and obligations, which is a shortcoming.

– Application of the appropriate criteria for the design of such a scheme against relevant criteria (including those identified in section 4.2 of the Joint Expert Report on capital expenditure incentives) may lead to differences between transmission and distribution in the design and application of a capital expenditure incentive scheme.

4.1.2 What has the AER proposed and why?

The AER is proposing to amend the RAB roll forward mechanism so that only 60 per cent of any overspend against forecast expenditure will be rolled into the asset base.

The AER has proposed the change on the basis that it considers that the Rules may not provide sufficiently strong incentives to ensure that only efficient investment occurs. The AER indicates that this is particularly an issue where the regulated cost of capital is higher than the actual cost of capital or where a network business is responding to a broader range of incentives than just financial incentives.

The AER also states in its proposal that the current RAB roll forward mechanism creates incentives for network service providers to incur more than the efficient levels of capital expenditure in some circumstances, particularly in the latter stages of the control period.

4.1.3 Is there a problem that needs to be addressed?

Grid Australia agrees that there are imperfections in the current incentives to minimise capital expenditure. In particular, Grid Australia recognises that the strength of the incentive to pursue efficiency gains under the current arrangements declines towards the end of the regulatory period.

That said, while it is difficult to draw any firm conclusions about the impact of the current design of capital expenditure incentives at this early stage of their application, Grid Australia notes that there is no evidence of transmission businesses spending more than efficient levels of expenditure. In addition, based on present expectations no transmission business forecasts that actual expenditure will be materially more than the forecast allowance during the TNSPs' current regulatory periods.

The assertion by the AER that the issue of capital incentives is aggravated by any differences between the regulated cost of capital and a business' 'actual' cost of capital fails to recognise that it is future expectations of the cost of capital, rather than the current 'spot' rate, that impacts on incentives for investment. Given the long-lived nature of network investment there is considerable uncertainty about how the future regulatory allowance will track against actual costs of capital. It therefore is unlikely that businesses would make investments on the expectation that any current 'wedge' would persist into the long term (particularly where allowances are being affected by short term financial market instability, as at present).

Grid Australia considers it is important to recognise that there are a number of other elements of the framework that limit the incentive, and capability, for transmission businesses to incur inefficient capital expenditure. For instance, before undertaking any significant investment on the network a transmission business is required to publically consult on the costs and benefits of a project through the Regulatory Investment Test for Transmission (RIT-T). The Rules allow interested stakeholders to challenge the need and efficiency of a particular project at this time. In addition, under the revised planning arrangements for the NEM, AEMO has an increased function with respect to investment planning and its input into RIT-T assessments. This involvement by a well-resourced third party places a further discipline on the efficiency of transmission investments.

In addition, internal cashflow constraints arising from need to maintain credit ratings and debt covenants can also limit network business' investment behaviour in the short run. This has become particularly relevant with higher funding costs and tighter requirements from credit agencies post GFC. Higher investment requirements from aging networks and demand growth, have also combined to squeeze free cashflow.

It is relevant to note that, at least in the context of transmission, other commentators, such as Professor Garnaut, have expressed the exact opposite concern for some aspects of transmission investment.[38] In particular, there have been concerns raised that network businesses do not undertake sufficient investment in inter-regional transmission capacity. Noting that in any event constraints such as the planning framework and the RIT-T limit the scope for inefficient capital expenditure, if, as the AER suggests, network businesses have incentives to incur more than efficient levels of capital expenditure, and these were acted on, we would expect to see a rush for investment in inter-regional transmission lines.

4.1.4 Does the proposal put the right balance on prescription and discretion?

Grid Australia does not consider that the proposal places the right balance between prescription and discretion. The capital expenditure incentive scheme proposed by the AER is a highly prescribed approach to implementing an incentive scheme. The

[38] Garnaut, R., *Garnaut Climate Change Review – Update 2011, Update Paper eight: Transforming the electricity sector,* March 2011, p. 34.

AER's proposed scheme 'hard-wires' the detailed operation of a capital expenditure incentive into the Rules. As a consequence, the AER has not provided itself with any flexibility in the design of the overall scheme or how it may apply to individual businesses. This contrasts with the approach taken to other incentive schemes in the current Rules.

As identified in section 2.2.2, when matters involve a number of 'moving parts' and are influenced by decisions on other elements of the framework, less prescription in the Rules may be desirable. As noted in section 3.3. of the Joint Expenditure Report on capital expenditure incentive arrangements, there are many aspects of detail that need to be addressed to implement an effective incentives framework, such as achieving the appropriate balance between incentives, managing risk appropriately, and tailoring incentive schemes to either particular circumstances or specific businesses. Indeed, the reason that the AER's scheme appears so simple is because the AER has failed to turn its mind to many of the complex issues that need to be addressed to implement a well-functioning incentive scheme for capital expenditure. Therefore, it is appropriate that some level of flexibility and discretion is provided with respect to the implementation of incentive mechanisms.

Discretion on the specific design of other incentive schemes is currently provided in the Rules by requiring the AER to consider principles or criteria when developing a scheme. As a result, the AER is provided with flexibility that enables schemes to take into account the numerous matters of detail associated with incentives. Conversely, the level of codification proposed by the AER for its capital expenditure incentive scheme severely restricts its flexibility. The implications of this restricted flexibility are:

- It constrains the AER's ability to achieve balanced incentives across the framework by locking in the 'power' of the incentive. Indeed, the fact that the AER's scheme would be codified in the Rules means it would also be restricted in its capacity to change the power of other incentives in the framework given this would lead to an unbalanced incentive framework.

- It removes the scope for the power of the incentive scheme to vary across businesses. A regulator may choose to set a difference incentive power, and hence sharing rate, across businesses for a number of reasons. These reasons include the expected responsiveness of a business to an efficiency incentive or the capacity to forecast capital expenditure accurately.

- It does not allow for consideration of key differences between transmission and distribution frameworks. Differences for transmission that would need to be factored into the design of an incentive framework include the greater lumpiness of the typical investment projects, different coverage of the service incentive scheme and service obligations, the increased role of national planning and investments associated with interconnection, and increased interaction with generators and wholesale market outcomes. Grid Australia notes that a number of the issues that are relevant to the design of a capital incentive scheme for transmission – most notably, the breadth and strength of incentives on TNSPs for service delivery – are a key issue in the AEMC's Transmission Frameworks Review.

It is also relevant to recognise that the AER's proposal ignores that even if a transmission business' actual expenditure exceeds forecast expenditure that this does not imply that the expenditure was inefficient. This particular issue has been addressed in the Joint Expert Report on capital expenditure incentives. The report notes that the efficient level of expenditure can turn out to be materially different to the forecast efficient level, and that setting an incentive scheme to encourage network businesses to spend the approved forecast will encourage inefficient behaviour.[39]

> *"Thus, the expenditure forecast may well turn out to be materially different from what transpires as the efficient level, in which case attempting to promote that level of expenditure would be in direct conflict with the NEO. This is particularly so in relation to the later years of the regulatory control period – where the forecast was determined up to four or five years previously."*

The report also observes that the AER's assumption that its forecast will be the efficient level demonstrates a misunderstanding of how incentive regulation works:[40]

> *"Thus, while an estimate of efficient future expenditure levels is required in order to set price levels, incentive regulation works by setting financial incentives so that NSPs reveal the efficient level of expenditure through their actions, which includes responding efficiently to changes in expenditure requirements as discussed above. It follows that implementing an incentive scheme that attempts to encourage NSPs to spend the forecast that was approved by the regulator at the previous price review is assuming a degree of knowledge on the part of the regulator that, when designing incentive regulation schemes, is generally assumed not to exist"*

The proposition that expenditure above forecast need not be inefficient is borne out with the ACCC/AER's previous assessments of actual expenditure under the ex-post regime, where amounts in excess of forecast with few exceptions were deemed to be efficient and prudent. The AER's proposal, therefore, potentially penalises transmission businesses from meeting their regulatory obligations where factors outside of their control would cause them to spend more than forecast. Instead, incentives should seek to encourage transmission businesses to minimise costs irrespective of their relationship to forecast amounts.

Grid Australia notes that it could be claimed that the change proposed by the AER is not a pure incentive scheme but only an alteration to the RAB roll-in mechanism. However, it should be recognised that mathematically the same outcome (and the

[39] Joint Expert Report, *Design of Capital Expenditure Incentives,* December 2011, p.6.

[40] Ibid.

same sharing ratio as proposed by the AER) could be achieved through an EBSS style mechanism. That is, changes to the RAB roll-in mechanism are simply a substitute approach for developing an explicit capital expenditure incentive.

4.1.5 Could existing discretions achieve the same outcomes?

The AER has the scope under the distribution Rules to enhance the incentives for efficiency of capital expenditure through developing an efficiency benefits sharing scheme (EBSS). However, this discretion is not extended to transmission. Therefore, for distribution only the AER has the discretion to achieve the same outcome as its proposed Rule under the current framework.

Grid Australia notes that the development of a well-designed capital expenditure incentive mechanism requires the consideration of a number of factors, some of which may be unique to either transmission or distribution networks. These factors, when properly considered, can impact on the design and application of a capital expenditure incentive scheme. Section 6.4 of the Joint Expert Report on capital expenditure forecasts commented on the impact that different factors can have on the design of a well functioning incentive mechanism.[41]

> *"One implication of our discussion in Chapter 4 of the factors relevant to the design of a capital expenditure incentive scheme, and as summarised again above, is that the optimal scheme will depend upon the relevant facts and circumstances. In particular, the breadth and power of incentives with respect to service performance, and the breadth of service related obligations, are a key consideration when selecting the incentive rate for capital expenditure efficiency. This is because care is required to ensure that the incentives provided to minimise capital expenditure do not merely encourage a reduction in service performance that is inefficient. The nature of the projects that are undertaken will also affect the risk that may be created by strengthening the incentives with respect to capital expenditure, with the potential for windfall gains and losses expected to be higher if projects are 'lumpier' and whose timing is dictated by uncertain, exogenous factors (like demand growth). This fact is also relevant to the selection of the incentive rate as well as the importance of including mechanisms within the scheme to ameliorate this risk. Moreover, the characteristics of the typical project are also relevant to the design of mechanisms to identify where projects are either advanced or deferred between regulatory periods."*

The Joint Experts Report then went on to identify a number of differences between transmission and distribution that they expected could lead to differences to the optimal scheme between the sectors.

> *"By way of example, we note that one of the important roles that transmission performs is to provide access to the generation sector and to undertake projects that deliver 'market benefits' – which include transmission projects that are undertaken to reduce the costs of generation. These types of project are different from typical distribution projects (which principally are directed to ensuring reliability of supply to*

[41] Joint Experts Report, *Design of Capital Expenditure Incentives,* December 2011, p.42.

final customers) and for which there may not be complete coverage with respect to service incentives and obligations. In addition, transmission capital expenditure tends to be more dominated by a small number of very large projects than for distribution, thereby affecting the risks that may be created – and hence need to be addressed – in the design of the incentive scheme.

Lastly, we note that the AEMC's parallel Transmission Framework Review is addressing matters that are relevant to the design of a capital expenditure incentive scheme for transmission. One of the key issues for that review is the interaction between transmission and generation, including the breadth of the incentive arrangements applying to transmission. Accordingly, further detailed development of NSP capital expenditure incentive schemes may need to consider these differences expressly, having regard to the outcomes of the Transmission Frameworks Review, among other matters."

Grid Australia notes that the Rules include some guidance to the AER that direct it to consider some relevant factors when designing an efficiency benefits sharing scheme. It is important to highlight, however, that the AER has proposed a scheme that would not be consistent with these principles for under the Rules. These principles for transmission include:

- The need to provide network businesses with a continuous incentive to reduce operating expenditure
- The desirability of both rewarding network businesses for efficiency gains and penalising efficiency losses
- Any incentives that a network business may have to inappropriately capitalise operating expenditure

The AER proposal, however, fails when assessed against each one of these principles:

- The AER's proposed scheme does not provide a continuous incentive to reduce operating expenditure across each year of the regulatory period. Instead, the proposed scheme retains a recognised imperfection of the existing incentives for capital expenditure. Indeed, the penalty for a business if it expects to overspend in every year is particularly high as it will incur a loss of five years of WACC and then recover only 60 per cent of the residual value.
- The scheme is asymmetric and hence would only be an effective incentive if a business expects to overspend. Under the scheme a network business would not expect to recover efficient costs as they would lose if required to overspend, but not receive a corresponding benefit if there is an opportunity for an underspend. A key objective of financial incentives is to encourage businesses to reveal their efficient costs, however, the asymmetric nature of the scheme means that this objective would not be realised under the AER's proposal.

- The scheme does not facilitate balanced incentives across the framework. As previously stated, the fact that the sharing ratio is effectively hard-wired in the Rules means that the AER has little scope to change the power of either the capital expenditure incentive or other incentives within the framework.

Importantly, the incentive power that would flow from the AER's proposed scheme for a business that expected to overspend would be extremely high in the early years of a regulatory period, and have the potential to dissuade efficient projects from being implemented. The Joint Expert Report on this matter observes as follows:[42]

> *"Thirdly, the incentive power that would be created for entities that expect to overspend would be extremely high at the commencement of the regulatory period (minimum rate of 53.8 per cent if depreciation is excluded, 80.6 per cent for an asset with a 7 year life) and remain high even in the last year (40 per cent in all cases). This incentive power will be higher than what applies to operating expenditure in all years (where the incentive power is in the order of 30 per cent, depending on the discount rate applied) and so create incentives inefficiently to substitute away from capital expenditure towards operating expenditure in all years of the regulatory period. Incentives to avoid capital projects – even at the expense of service performance – are likely, particularly where there are 'gaps' in service incentives or obligations (for example, transmission projects that are not driven by a reliability obligation)."*

Grid Australia considers that the inability for the proposed scheme to meet the criteria for the EBSS in the Rules is a fundamental flaw and provides strong evidence that the proposed Rule change is unlikely to promote the NEO. Grid Australia notes, in addition, that the asymmetric nature of the AER's proposed scheme also means that the proposal would be unlikely to meet the Revenue and Pricing Principles contained in section 7A of the National Electricity Law. In particular, the requirement that a network service provider should be provided with a reasonable opportunity to recover at least the efficient costs incurred in complying with a regulatory obligation or requirement or making a regulatory payment.[43]

4.1.6 The preferred solution

Grid Australia considers that the matter of applying incentives for efficient capital expenditure is an issue that requires further consideration. This is particularly the case for transmission given the important role for incentives more generally that has been identified as part of the Transmission Frameworks Review. Grid Australia welcomes the consideration of extending to the AER the discretion to apply an EBSS to capital expenditure for transmission as it currently has for distribution.

As a condition of this, however, Grid Australia considers it is essential that the AEMC undertake a review of the current EBSS criteria for transmission and distribution to

[42] Joint Experts Report, *Design of Capital Expenditure Incentive Arrangements, Expert Report to the Energy Networks Association,* December 2011, p.39

[43] Section 7A(2)(b) of the National Electricity Law.

ensure that they will direct the AER to the important issues that are specific for transmission, as well as putting in place appropriate safeguards. Grid Australia's preliminary view, which is expanded on in chapter 4 of the Joint Expert Panel report on capital expenditure incentive arrangements, is that the current criteria are deficient in that:

- The AER is not required to make an explicit decision about the incentive power of the scheme after taking account of the specific features of the sector in question (such as the operation of coverage of service incentives and obligations and the characteristics of the types of projects that transmission entities pursue)

- There is no requirement for the AER to consider measures to ameliorate and limit the risk that such a scheme may cause, in particular where transmission businesses have limited control over expenditure, which is essential for a transmission business in light of the lumpiness of investment in the sector, and

- There is no requirement for the AER to consider other elements of the framework that impact on expenditure decisions by transmission businesses, in particular, service and reliability obligations and the requirement to undertake a RIT-T for investments above a certain threshold value.

In parallel with reviewing the criteria for the operation of an EBSS, Grid Australia considers that the AEMC should also review the current criteria that apply to identification of contingent projects. In a framework with higher powered capital expenditure incentives, the contingent projects mechanism could be an effective tool for minimising the scope for windfall gains and losses and so allowing for higher-powered incentives than otherwise. However, Grid Australia's experience to date has been that the AER has applied the contingent project framework in a rigid manner and it has been difficult to have projects defined as contingent. Therefore, Grid Australia considers it is appropriate for the AEMC to review the criteria that applies to the contingent projects framework to ensure that the mechanism is effective as a risk management tool for businesses and consumers.

Grid Australia welcomes the Commission's further consideration of these matters.

4.2 Option to develop other incentive schemes

4.2.1 Overview of Grid Australia position

- The proposal from the AER to give itself a general power to implement other incentive schemes is inconsistent with the regulatory framework that exists in the NEM
- At present, specific classes of incentive schemes are authorised by the Rules, and the Rules define appropriate criteria and safeguards for those particular schemes. Within this framework there is discretion for the AER regarding the detailed design of schemes
- The broad power proposed by the AER could allow the criteria and protections that apply to specific incentive schemes to be bypassed, and more generally permit the AER to implement new schemes without sufficient guidance (it is noted that the AER has not proposed that the general scheme would put in place any protections – like revenue at risk – or even to consider important issues such as the risk created by the scheme).

4.2.2 What has the AER proposed and why?

The AER has proposed that it be able to develop and publish other incentive schemes beyond the EBSS, Service Target Performance Incentive Scheme (STPIS) and Demand Management Incentive Scheme (DMIS) for distribution, subject to the AER having regard to the following:

- The benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme
- Possible effects of the scheme on incentives for the implementation of non-network alternatives
- The need to ensure that the incentives are sufficient to offset any financial incentives the NSP may have to reduce costs at the expense of service levels
- The willingness of the customer or end user to pay for improved performance in the delivery of services, and
- Any other incentives available to network businesses under the Rules or under a relevant revenue determination.

The AER has also proposed amendments to the requirement in Chapter 6A that it *must* develop an EBSS and STPIS scheme for transmission businesses. Instead, the AER proposes that it have the option to develop an EBSS and STPIS.

The AER has proposed to provide itself with the flexibility to develop other incentive schemes on the basis that it considers regulatory best practice for incentives is continually evolving and the current process, through the Rules, is too cumbersome, costly and time consuming.

4.2.3 Is there a problem that needs to be addressed?

The Rules already provide scope for the AER to modify incentive schemes where evolution requires changes to existing schemes or innovative approaches to be taken. The specific design of incentive schemes is left to the discretion of the AER based on guidance in the Rules. However, the AER has not identified in what way its existing discretions prevent it from developing new schemes, or any schemes applied internationally that could not be developed within the existing framework.

The current Rules framework has already demonstrated a capacity to allow for innovation in incentive design. For instance, under the current Rules based framework the AER has made multiple changes to the Service Target Performance Incentive Scheme (STPIS). The most significant being the introduction of a Market Impact of Transmission Component (MITC). The AER is now undertaking a significant review of the STPIS for the development of a fourth version of the incentive scheme. This is a broad ranging review and will consider a number of fundamental issues for the scheme, including whether it should be extended to incentives for improving network capability.[44]

We note, in addition, that for distribution the AER have undertaken a variety of approaches to the demand management incentive scheme, to the extent that different schemes apply in different jurisdictions.

Incentive schemes can have a significant impact on the financial performance of a business and their behaviours, therefore, it is important that their development be subject to sufficient scrutiny and input from stakeholders. If a proposed incentive scheme is sufficiently unique that the current discretions in the Rules are insufficient for its development and implementation, Grid Australia considers that such a change is important enough to be subject to the transparency and rigour of the full Rule making process. Doing so supports the governance framework in the NEM and provides recognition to the discretions afforded to the AEMC and AER in Australia.

[44] AER, *Issues Paper, Electricity transmission, Service Target Performance Incentive Scheme,* October 2011, p. 8. Grid Australia notes that the AER has extended its detailed review of the STPIS for transmission in view of the timing of the Transmission Frameworks Review and the breadth of issues raised in submissions to its Issues Paper

Grid Australia notes in any case, that when making significant amendments to schemes or when developing a new scheme the AER has itself taken considerable time to make a decision. For instance, for its review of the STPIS, which is a scheme that is already well developed and mature, the AER has scheduled a five and half month timetable. When developing the initial EBSS the AER process lasted for eight months. This compares to a six month Rule change process through the AEMC. Grid Australia considers it is important that this amount of time is taken for important amendments to the framework.

4.2.4 Does the proposal put the right balance on prescription and discretion?

Grid Australia considers that the AER proposal does not place the right balance on prescription and discretion. This is because it affords the AER excessive discretion in the creation of incentive schemes.

The principles proposed by the AER for its broad power for incentives schemes are significantly broader than the current principles for incentive schemes. Grid Australia considers it is appropriate for the AER to have regard to specific criteria or principles with respect to different schemes. For instance, the STPIS places a five per cent limit on the revenue at risk under the scheme. No such provision applies in the AER's proposed broad incentive power. Therefore, under its proposed Rule this important safeguard would be lost and the AER would be free to set a significantly greater amount of revenue at risk.

The need for important guidance on specific schemes to remain in the Rules is reinforced by the AER's proposed capital expenditure incentive scheme. As previously indicated, this scheme would not comply with the existing principles for expenditure incentives in the Rules. The inability for the AER to develop schemes that meet current objectives in the Rules demonstrates that there is a significant risk that it will be unlikely to apply broader discretion appropriately.

4.2.5 Could existing discretions achieve the same outcomes?

The Rules framework with respect to incentives is a principles based approach rather than a highly prescribed approach. Such an approach, while providing the AER with discretion, also ensures that it is provided with appropriate guidance on the development of schemes so that they are consistent with the AEMC's interpretation of the NEO. Given the level of discretion in the Rules, the AER is able to develop new approaches to incentives that take account of existing best practice. This is supported by its development of the market impact component of the STPIS.

4.2.6 The preferred solution

Grid Australia recommends that the AEMC reject the AER's proposal on the basis that it would not promote the NEO or the Revenue and Pricing Principles for the reasons outlined above.

4.3 Actual and Forecast depreciation

4.3.1 Overview of Grid Australia position

- A well designed capital expenditure incentive scheme should be the first preference for providing capital incentives with the arrangements for the treatment of depreciation being carefully considered with other elements of the Rules that are presently under review.
- Grid Australia considers that at a minimum, the Rules should provide flexibility about whether actual or forecast depreciation is applied.
- However, the use of actual depreciation as an incentive tool is a second best option for enhancing incentives to minimise capital expenditure.
  - The application of actual depreciation to the roll-forward of the RAB increases the power of the incentive at the cost of distorting incentives between short-lived and long-lived assets.
  - Accordingly, the AEMC may wish to consider the appropriateness of prescribing the use of forecast depreciation.

4.3.2 What has the AER proposed and why?

The AER has proposed an amendment to the roll-forward provisions in the Rules to allow it to adopt either forecast or actual depreciation. The AER considers that the proposed change provides it with flexibility to achieve a balanced capital expenditure framework. In particular, the AER is concerned that in some circumstances the use of actual depreciation may lead to higher windfall gains or losses than if forecast depreciation was adopted.

4.3.3 Is there a problem that needs to be addressed?

Grid Australia agrees that the existing approach to depreciation may limit the AER's ability to achieve a balanced capital expenditure framework. The purpose of applying actual depreciation in the current framework has been to increase the power of capital expenditure incentives.

However, Grid Australia notes that there is an incentive issue associated with the application of actual depreciation, namely that using actual depreciation creates a stronger incentive rate for short-lived assets than for long-lived assets. For example, saving a dollar in the first year of a regulatory period on the purchase of an asset with an economic life of seven years will result in the network business retaining 65 cents.

On the other hand, avoiding expenditure on an asset with a 50 year life results in the network business retaining only 29 cents. There is no economic justification for different incentive rates to apply to short-lived versus long-lived assets.

If an EBSS was introduced for capital expenditure, the application of actual depreciation to enhance incentives may become unnecessary, indeed retaining actual depreciation may lead to an over-powered capital expenditure incentive relative to other incentives in the framework. Grid Australia considers that applying an EBSS to capital expenditure for transmission, with the proper consideration of appropriate criteria and regard to transmission specific issues, should be the preferred approach to achieving effective incentives for efficient capital expenditure in the framework. A well designed EBSS allows for a higher powered incentive to be applied without the distortionary effects that are caused by including depreciation in the scheme.

4.3.4 Does the proposal put the right balance on prescription and discretion?

Given the potential distortions associated with applying actual depreciation, the proposal to have discretion over whether to apply actual or forecast depreciation is an improvement on the current arrangements. However, for the reasons identified in section 4.3.3 above, Grid Australia considers that providing discretion on the application of actual versus forecast depreciation may only afford the AER the opportunity to implement a second best solution to capital expenditure incentives. To the extent there are concerns about the power of the incentive to minimise capital expenditure, Grid Australia's preference would be for this to be resolved through a well-designed and fit-for-purpose capital expenditure incentives scheme.

4.3.5 Could existing discretions achieve the same outcomes?

The Rules presently require the AER to apply actual depreciation for transmission networks. Therefore, the AER is precluded from applying forecast depreciation to transmission businesses.

4.3.6 The preferred solution

Grid Australia considers that a well-designed capital expenditure incentive scheme should be the first preference for providing capital expenditure incentives. Therefore, the issue of applying actual depreciation as an incentive mechanism should be carefully considered having regard to the other elements of the Rules that are also presently under review.. At a minimum Grid Australia considers that the Rules should provide flexibility about whether actual or forecast depreciation is applied.

Grid Australia also considers that the AEMC may wish to consider the merits of prescribing the use of forecast depreciation given that retaining the option to apply actual depreciation is a second best approach to achieving a well-balanced and well-designed incentive framework.

5. Cost of Capital

This section addresses the Rule change proposals from the AER in relation to the process in the Rules for setting the weighted average cost of capital (WACC) for TNSPs, and its specific proposals in relation to the determination of the cost of debt. This section also addresses the Rule change proposals from the Energy Users Rule Change Committee (EURCC).

The comments below address separately the two groups of proposed Rule changes, namely:

- The AER's proposal for convergence between the transmission and distribution regimes, and
- The AER and EURCC proposals in relation to the guidance in the Rules on the calculation of the cost of debt, although observations are also made about the level of guidance on calculation of the cost of debt more generally in the Rules.

5.1 Process for setting the WACC

5.1.1 Overview of Grid Australia position

- Grid Australia supports a process whereby WACC parameters or methods are set every five years based on clear guidance in the Rules, and a process that continues to combine electricity transmission and distribution.
- However, the challenges of recent years in setting the WACC provide strong argument for Chapter 6A to be changed to accommodate exceptional circumstances.
  - Standard approaches for setting the WACC failed during the GFC, and experience has shown that a 'safety valve' that permits departures from inputs or methods in an AER Statement on the Cost of Capital (Statement) is essential to cope with such events.
    - The AER's proposal to bring forward the review of the Statement could not address GFC-type issues.
    - If the Statement is binding, the problems experienced with setting the cost of debt during the GFC that the AER has sought to remedy with its Rule change would be likely to remain.
  - Grid Australia notes that the framework in Chapter 6 provides a mechanism to accommodate GFC type events. In addition, the ability that distribution businesses have to take the AER's WACC decisions to merits review allows the correction of material errors that the AER later

conceded. It is incongruous that those errors cannot be remedied for transmission businesses.

– In addition, Grid Australia notes that the availability of merits review on the Statement would offer administrative efficiencies and the AEMC should therefore be cognisant of the relationship between the rules and the institutional framework when assessing the current Proposed Rule Changes.

5.1.2 What has the AER proposed and why?

The AER has proposed that the process that is applied for setting the regulatory WACC for distribution will be aligned with the process for transmission in Chapter 6A of the rules.[45] The effect of this Rule change would be that, for both transmission and distribution:

- Specific parameters for many of the WACC inputs, and detailed methodologies for others, will be determined on an industry-wide basis and specified in an instrument referred to as the 'Statement on the Cost of Capital', and
- The Statement will be required to apply in all price/revenue determinations until it is reviewed.

A consequence of the AER's proposal for the distribution businesses is that the capacity for aspects of the Statement to be subject to merit review would be removed through a Rule change. This is appears contrary to the MCE's policy intent given the Standing Committee of Officials (SCO) were cognisant at the time the distribution Rules were developed that linking the WACC to the regulatory determination for distribution meant that the AER's consideration will be merits reviewable.[46]

The AER has proposed dealing with unexpected changes in financial markets by providing itself with the ability to review the Statement earlier than the scheduled five years that is currently reflected in Chapter 6A.

The AER's rationale for convergence between the different sectors is largely based on administrative convenience. The AER notes that most of the parameters in the WACC are independent of business/industry specific considerations[47] and that there will be reduced administrative costs and increased certainty through codifying the

[45] It is noted that the AER also proposes changes to the National Gas Rules to pursue greater coordination of regulatory WACC setting between electricity and gas. It is noted that the differences between the existing electricity and gas regimes imply that such a change raises a number of additional issues. These matters are addressed in depth in the ENA submission.

[46] SCO, *Table 1: SCO Response to Stakeholder Comments on the Exposure Draft of the National Electricity Rules for Distribution Revenue and Pricing (Chapter 6)*, p 17 (item 50).

[47] AER, *Economic regulation of transmission and distribution network service providers: AER's proposed changes to the National Electricity Rules, September* 2011, p 67.

parameters to be applied to all service providers.[48] The AER states that an unintended consequence of having different WACC frameworks is that they could produce different benchmark parameters (in particular for the market risk premium (MRP)) that should be the same.[49]

The AER's rationale for convergence to the Chapter 6A framework is to avoid what the AER contends is a continual 'WACC review mode' under the Chapter 6 arrangements, where distribution businesses are able to present persuasive evidence for a departure from the Statement at every price reset. It has also argued that the ability to depart from the Statement permits distribution businesses to engage in 'cherry-picking' of WACC parameters in individual decisions, and that it is precluded from assessing the overall reasonableness of the WACC.

The AER has also argued that the ability for the distribution businesses to challenge AER determinations of WACC parameters has resulted in Tribunal merit reviews involving a 'spurious' level of precision and the scope for 'cherry-picking' of those components network businesses consider unfavourable. Accordingly, it is apparent that a key consideration for the AER for the Rule change is to remove the existing scope for distribution businesses to take the AER's WACC decisions to merit review.

5.1.3 Is there a problem that needs to be addressed?

While Grid Australia agrees that deficiencies exist with the current rules, the true deficiencies are counter to what the AER contends. Rather than Chapter 6 being too flexible and therefore creating administrative effort for the AER, in reality the Chapter 6A process has proven to provide insufficient flexibility to respond to changing market conditions and errors that are found in the AER's decisions. It also follows that, in the context of the existing regulatory framework (including appeals mechanisms) that a mechanism is required to accommodate exceptional circumstances in financial markets.

Convergence of WACC regimes

Grid Australia considers that the existing process whereby the AER undertakes a five yearly review of WACC parameters and methods for the electricity transmission and distribution businesses is an appropriate process. This process permits a concentrated focus on WACC issues, thus saving the AER and businesses administrative costs and allowing for a better consideration of the issues, in the context where the regulatory regime for the two sectors already is very similar. Grid Australia supports the ENA's position, however, that the argument for combining gas businesses within the same review is less compelling. Decisions in the electricity process already set a *de facto* precedent where relevant for the AER's gas decisions,

[48] AER, *Economic regulation of gas distribution and transmission services: AER's proposed changes to the National Gas Rules,* September 2011, p 3.

[49] AER*, Economic regulation of transmission and distribution network service providers: AER's proposed changes to the National Electricity Rules, September* 2011, p 67.

and the regulatory regimes between electricity and gas are sufficiently dissimilar that the changes required to align all regimes formally may well create implementation costs and uncertainty that outweighs any prospective benefit.

Need for a safety valve

Grid Australia considers that the experience over recent years suggests overwhelmingly that a mechanism is required to accommodate exceptional circumstances in financial markets. Under the current Chapter 6A Rules, the Statement is required to be applied irrespective of whether shocks to financial markets have occurred over the intervening period or whether it is shown to contain errors. This approach contrasts with the framework that applies for distribution whereby decisions in the Statement can be reopened where persuasive evidence exists. The need for a 'safety valve' is examined in depth in the Joint Expert Report on the Cost of Capital provided in support of the ENA submission, which concludes as follows:

> *"The AER's proposal to move TNSPs, DNSPs and gas pipelines to a common framework for determining the rate of return that, in essence, reflects that already established in chapter 6A of the NER involves a substantial risk of setting a WACC that is not commensurate with prevailing conditions in the market for funds. Locking-in the WACC parameter values, methods and credit ratings gives rise to the risks that:*
>
> - *the pre-specified WACC parameters are no longer appropriate due to changes in financial market subsequent to the SoCC;*
> - *the SoCC will specify methods dependent on data or information that subsequently ceases to exist; and*
> - *the SoCC contains errors that cannot be adequately addressed without merits review.*
>
> *In our opinion, the experience since the current rules were put in place demonstrates that any WACC framework must contain a mechanism that is able to be invoked by any party in relation to any individual decision in order to ensure that the rate of return is commensurate with the prevailing conditions in the market for funds. With the benefit in hindsight of financial market developments over the past five years, the absence of any credible safety valve mechanisms amounts to a fundamental design flaw in both the chapter 6A provisions of the current NER and the framework that is now proposed by the AER."*

Grid Australia notes that this inability to depart from the Statement under Chapter 6A is having a material detrimental impact on transmission businesses. The risks for investors in these businesses are real and can be expected to deter the appetite for investment in efficient transmission development. In addition, this outcome appears inconsistent with the Pricing and Revenue Principles set out in the NEL in that it appears to deny businesses the opportunity of recovering at least the efficient costs of meeting regulatory obligations.

In particular, notwithstanding the AER's concession that the gamma value that it set in the 2009 WACC review is erroneous and the Tribunal's findings of more errors, the Rules require the erroneous value to continue to be applied to TNSP determinations until a new Statement is issued.

In addition, the 'formula' and parameters in Chapters 6 and 6A predicted substantial reductions in the cost of equity after the commencement of the Global Financial Crisis, which is contrary to any expectation. Information presented in the Joint Expert Report on WACC observed that in decisions since 2006, the 'formula' and parameters in Chapters 6 and 6A generated estimates of the cost of equity at the time of each decision of between 10.9 and 11.7 per cent in the period prior to the onset of the worst of the Global Financial Crisis (September 2008)[50] However, materially lower estimates have applied at the time of a number of decisions since the commencement of the Crisis, including estimated costs of equity of 9.8 per cent and 9.4 per cent at the time of the TransGrid/Transend final decision and Powerlink draft decision,[51] respectively. The proposition that the cost of equity fell during the Global Financial Crisis, and the ongoing financial market instability, by up to 2 percentage points is out of step with the views of informed commentators, but is not something that is able to be questioned under the current Rules framework.

Problems with Chapter 6 are exaggerated

Grid Australia also considers the problems the AER has claimed with administering Chapter 6 to be exaggerated at best and to ignore the challenges in estimating the WACC over recent years, including those posed by the Global Financial Crisis.

One of the AER's concerns is that it has been forced to engage in 'continual WACC review mode' as distribution businesses have argued for departures from the Statement. In fact, distributors have only argued for changes from the Statement in relation to the gamma value and the market risk premium (although changes in relation to the risk free rate may follow in the future if the current market conditions continue).

- In relation to gamma, this was a matter upon which the AER subsequently conceded a material error, and where the Tribunal found further error. These challenges were a response to the widespread dissatisfaction with the AER's treatment of this matter during the 2009 WACC review and the absence of a proper review option from that decision.

[50] The estimates reflect an averaging period for the risk free rate that coincides with the release of the final decision, and so may differ to the estimates the AER adopted.

[51] TransGrid and Transend had proposed using an earlier averaging period – and this was upheld by the Tribunal – and so received a higher cost of equity than reported here. However, the AER re-wrote the processes for determining the averaging period in the 2009 WACC Statement, which removed the ability for TNSPs to propose an averaging period that was some distance from the time of the final decision.

- In relation to the market risk premium, the fact that some distribution businesses have sought to argue for an increase to the market risk premium should not be unexpected in light of the continued instability in financial markets, and the widespread belief that investors are currently requiring materially higher returns than prior to the Global Financial Crisis.

The AER is also incorrect to assert that WACC parameters are slow to change and so reviews at five yearly intervals are sufficient. While this may be correct in normal situations, the experience over recent years is that the character of financial markets can change very quickly (and with very quick changes overwhelmingly being negative events).

In addition, the flexibility under the Chapter 6 regime to consider whether there is a persuasive case for change is not an open invitation for 'cherry picking', as the AER contends. If changing one parameter means that a change to another is justified (that is, where they are interrelated), then the AER is able to make that change – the flexibility is symmetric. Moreover, the AER is able to depart from the Statement wherever persuasive evidence exists – and indeed the AER recently has issued a draft decision for a distribution business where the AER has concluded that a departure from the Statement is justified.[52] In addition, the Tribunal is also empowered to consider whether correcting for one error requires other matters to be addressed.[53]

Moreover, the AER is incorrect to assert that Chapter 6 has resulted in attempts to by DNSPs to pursue a 'spurious' degree of precision. The matters that have been challenged – the gamma value and market risk premium – are both matters where there was a serious issue at stake. As noted above, the gamma value in the Statement involved material error on the part of the AER, and at the heart of the argument about the market risk premium is the question of how the cost of equity has been affected by the Global Financial Crisis and ongoing financial market instability – both of which are anything but 'spurious'. With respect to review by the Tribunal, 'spurious' issues would never satisfy the hurdle required before appeals will be heard.

Lastly, we observe that a related change the AER has proposed is to reduce the degree of prescription in the rules with respect to the determination of the debt risk premium, but with the detail of the method being set out in the Statement. If such a regime had existed prior to 2009, then it is likely that the problems the AER has experienced would have continued to be present under the Chapter 6A regime.

52 The AER has issued a draft decision for Aurora Energy that revises the market risk premium from 6.5 per cent to 6 per cent (AER, 2011, Aurora Energy Draft Decision, November, p.27), following previous decisions for gas businesses. However, a challenge to this decision (as happened with the gas businesses) should be expected – the AER's decision to revise down the figure is unusual given the ongoing financial market instability.

53 NEL, section 71O(1)(b).

The AER's difficulties were caused by the rules requiring the debt risk premium to be inferred from Australian corporate bonds. However, even if the AER had the opportunity to alter this principle in the 2009 WACC review, it is most likely that the AER would have incorporated the rule provisions into its Statement – after all, inferring the debt risk premium from Australian corporate bond information had years of acceptance by regulators and regulated businesses, and the difficulties with that method had at that time only started to emerge.

Merits review of the Statement would offer administrative efficiencies

Lastly, Grid Australia notes that if merit review of the Statement was subject to merit review, the dissatisfaction with the AER's conclusions on gamma and the MRP in the 2009 WACC review could have been tested upfront through a single, efficient process. This would have avoided the need for piecemeal reviews in the context of individual determinations and the consequent perception that the merit review process was being overused.

Grid Australia urges the AEMC to be cognisant when assessing the current rule change proposals of the relationship between the rules and the institutional framework, and to consider the full range of options that are available for improving the efficiency of regulatory processes.

5.1.4 Does the proposal put the right balance on prescription and discretion?

As discussed above, a key deficiency with the current process for setting the WACC is that a Statement, once made, provides the AER with too little flexibility (discretion) to determine a WACC that would remain robust in the face of sudden and material changes in capital market conditions. It also contains insufficient flexibility to permit the AER to remedy errors that had become apparent in the previous Statement.

It is noted that the AER has proposed that the WACC Statement could be brought forward as a means of responding to unexpected capital market events. Grid Australia agrees with the conclusions of the Joint Expert Report on WACC that the time required to review and replace a Statement means that bringing forward the review would not be sufficiently quick to address the implications of sudden changes in capital market conditions.

A second question is whether the Rules provide the appropriate balance of prescription and discretion in relation to the determination of the Statement itself. This matter is addressed in section 5.2.

5.1.5 Could existing discretions achieve the same outcomes?

From the discussion above, it is clear that for transmission, the AER has insufficient discretion under Chapter 6A to ensure that the WACC estimate that it applies remains robust in the face of changes in market conditions or other evidence that suggests that the application of the prevailing WACC Statement would produce inappropriate outcomes.

The appropriate discretion does exist within the Chapter 6 framework.

5.1.6 Preferred solution

As discussed above, Grid Australia supports the current process whereby the AER determines standard inputs and methods for the WACC across electricity transmission and distribution via a 5-year review. Grid Australia also considers that this decision should be subject to merits review.

However, Grid Australia considers that recent experience has demonstrated shortcomings in the Chapter 6A framework. In particular, it notes that the experience of recent years demonstrates that the ability under the Chapter 6 process for the AER to depart from the Statement where there is ‘persuasive evidence’ is essential for ensuring that the WACC estimate can remain valid in the face of exceptional circumstances and compelling evidence of error in the prevailing Statement.

It is noted here that the Chapter 6 process allows a departure from the Statement where there is ‘persuasive evidence’ justifying a departure, with the evidence considered in the context of the principles underpinning the current Statement. This is the same hurdle that exists before the parameters or methods in a Statement are permitted to be varied from what previously had applied (which is something the AER has proposed to delete). In the following section, Grid Australia notes it considers that the ‘persuasive evidence’ hurdle before a new Statement can depart from the previous Statement should remain.

5.2 Guidance on the cost of debt and other WACC parameters

5.2.1 Overview of Grid Australia position

- Grid Australia agrees that problems emerged during the Global Financial Crisis with deriving a benchmark debt risk premium from the Australian corporate bond market, and that it is appropriate for the Rules to permit additional classes of information to be considered.
  - However, the discretion the AER seeks is unnecessarily wide. Key constraints for determining the cost of debt – namely that it reflect a benchmark for an Australian borrower, with the benchmark assumptions (term and credit rating) transparently disclosed – should remain. There is also merit in removing the need for the same risk free rate to be used to estimate the cost of equity and cost of debt.
- However, the AER’s Rule change proposal demonstrates that inadequate guidance in the Rules remains for many of the parameters for the WACC, with

much of the initial guidance effectively overwritten by the 2009 WACC Statement. Further guidance in the Rules should be considered to ensure the AER is properly guided. Grid Australia also considers it is essential for the 'persuasive evidence' threshold to be met before a new Statement can change from the previous Statement should remain.

- Many of the EURCC conclusions and recommendations are flawed.
  - Its recommendation that owner-government borrowing costs be applied for government owned firms ignores the risk that tax payers bear from these activities and ignores the downstream resource misallocation that would arise where different network charges result purely on account of ownership.
  - Its conclusion that current allowances for the debt risk premium provide excessive returns because they exceed the historical debt costs ignores the difference between an allowance that reflects the spot rate (as it does here) and one based on embedded debt costs (which is what the EURCC ultimately propose).
- However, Grid Australia supports giving further consideration to changing to a regime in which the debt allowance reflects the embedded cost of debt for a benchmark financed entity, which is an important component of the EURCC proposal. That said, this would be a material change to the regime and potentially give rise to material implementation issues associated with preserving a consistent overall framework for setting regulated cost of capital parameters. Moreover, a number of important issues would need to be addressed, which include:
  - whether the 'embedded' component should relate to the whole cost of debt or just the risk premium element
  - how the benchmark debt cost at any point in time is to be determined, and
  - whether prices should continue to be revised continually during the regulatory period to reflect the change in the borrowing costs as the efficient portfolio is refinanced over time, or whether the debt allowance should be based in part upon forecasts.

5.2.2 What have the AER and EURCC proposed and why?

The AER has proposed removing from the Rules the requirement for the debt risk premium to be inferred from observed yields on Australian corporate bonds, as well as the requirement for the term of debt to align with the risk free rate that is used to estimate the cost of equity.

The AER identifies several issues with the definition of the DRP in clauses 6.5.2(e) and 6A.6.2(e) of the NER. The key issues are:[54]

- the DRP definition is too restrictive in its reference to a benchmark bond with a particular term to maturity, credit rating and domicile of the issuer;
- ambiguity in the definition of the benchmark, and in particular uncertainty as to what other factors are relevant to determining the benchmark set;
- inflexibility in dealing with changing market conditions; and
- apparent disparities between the benchmark cost of debt and the actual cost of debt for NSPs.

In addition, the AER has proposed removing the requirement in the Rules for there to be persuasive evidence before the AER issues a new Statement that departs from a position in the previous Statement. The AER argues that this hurdle may inappropriately restrict the AER's ability to determine an efficient rate of return. With respect to the stability of regulation, the AER commented as follows:[55]

> *"The AER considers that predictability and consistency are important considerations over the short to medium term, and are best achieved by conducting an industry-wide WACC review on a 'first principles' basis and then prescribing the outcomes of this review for transmission and distribution determinations for a specified period of time."*

Separately, the EURCC proposed changing the Rules so that the allowance for the cost of debt would be set at the actual cost associated with a benchmark debt portfolio, thus reflecting the embedded cost of debt for an efficient entity. Under its model, revenues/prices would be changed continually (that is, during the regulatory period) as the cost associated with this portfolio changes.

In addition, the EURCC proposed that the allowance for the cost of debt for government owned entities should reflect the borrowing costs for the owner-governments, which are materially lower than the borrowing costs for a stand alone, commercially financed entity.

The EURCC proposed that both of the measures set out above would be prescribed by the Rules.

While the EURCC raises a number of concerns with the current arrangements, its dominant reason is its view that the NSPs currently are earning excessive returns from the return on debt component of the WACC at present.

54 AER, *Economic regulation of transmission and distribution network service providers: AER's proposed changes to the National Electricity Rules*, September 2011, p 77.

55 AER, *Economic regulation of transmission and distribution network service providers: AER's proposed changes to the National Electricity Rules*, September 2011, p 75.

5.2.3 Is there a problem that needs to be addressed?

AER's concerns about the use of Australian corporate bonds

Grid Australia notes that this matter has been addressed in depth in the ENA submission, and concurs with its views.

In particular, Grid Australia accepts that the substantial changes to financial markets flowing from the Global Financial Crisis made it difficult to infer a benchmark cost of long dated debt from Australian corporate bonds. Thus, even though the method prescribed in the Rules was widely accepted by regulators and regulated entities prior to the Crisis, it quickly became a source of controversy and dispute in light of the unexpected changes to financial markets.

Grid Australia also notes that the difficulties experienced with applying a 'tried and tested' method to estimate the cost of debt during and after the Global Financial Crisis provide a good illustration of why the AER's proposal to lock-in parameters and methods set out in a Statement is inappropriate.

AER concerns about the persuasive evidence threshold

Grid Australia notes that the cost incurred in installing regulated network assets is typically recovered over periods of 40 years or more. It follows that investors are not just concerned about the returns that the regulator may offer in the next five year period, but are also concerned with the outcomes in the seven or more regulatory periods thereafter. It follows that investors place a high value on the predictability of regulation, of which the creation of a stable environment is a key contributor.

One of the characteristics of many WACC parameters is that the estimates obtained are imprecise (that is, they have a high standard error). This means that different people estimate the WACC and so with a 'blank sheet of paper', they could come up with economically material differences in estimates, even during normal market conditions. The prospect of a regulator conducting reviews over time and commencing each with a 'blank sheet of paper' would create the potential for unpredictable outcomes, and so materially diminish the incentive and capacity for continued investment.

The objective of the current 'persuasive evidence' threshold is to require the AER to take into account the benefits of stability in its decisions, and hence increasing the predictability of outcomes over time, and with it the incentive and capacity for investment. Moreover, it achieves this improvement in the investment environment without causing higher prices – the 'persuasive evidence' hurdle is symmetric, all it does is increase predictability.

Against this, the AER has not presented any compelling evidence that the current threshold has prevented it from changing a WACC parameter or method where it considered the evidence justified the change. Indeed, if anything, the AER's analysis has demonstrated that the threshold is not as high as intended and that attention should be focussed instead on amending the provision to deliver the intended stability of return outcomes.

Accordingly, no case has been made to remove the persuasive evidence threshold.

EURCC concerns about the appropriateness of current allowances for the cost of debt

The problem identified by the EURCC combines three separable issues:

- the issue of whether or not the cost of debt should be set by reference to the current cost of new debt (ie, a "spot rate") or by reference to an historical average (i.e. intended to reflect the cost of embedded debt);
- the issue of whether the benchmark cost of debt has been appropriately specified, i.e. whether or not Australian-dollar denominated corporate debt of the same maturity as the risk free rate is an appropriate benchmark; and
- whether the cost of debt for government owned businesses should be set by reference to private sector borrowing costs, as at present.

Again, the ENA submission addresses these matters at length, and the Commission is directed to that submission for a fuller consideration.

Turning to the first of these matters, the EURCC argument fails to recognise that the standard practice in Australian economic regulation has been to set the cost of debt allowance at the spot rate (that is, the rate that exists at the time of the decision) rather than based on embedded interest costs. These two methods for deriving a cost of debt will differ over time depending upon how the spot rate compares to the historical average, but neither would be expected to exceed the other on average over time. Indeed, comparing the outcome of the 'spot rate' method to the 'embedded cost' method at a time when corporate interest rates remain very high amounts to 'cherry picking' – undertaking the same analysis at an opposite point in the cycle would yield the opposite finding.

In addition, while there has been insufficient time to conduct a proper analysis, Grid Australia is concerned that many of the figures on actual debt costs that are presented in the EURCC submission are erroneous. In particular, in Table 2 while the 'spread' is identified as the spread over the swap rate, this spread is erroneously added to the government bond rate that applied at time of issue. These base interest rates are different, with the swap rate in recent times being 50 basis points or so above the bond rate (depending on the term), and so the 'approx. nominal rate' is understated by about this amount.[56] The large table of issues (Table 1) also has a

[56] The first of the debt issues in Table 2 was included in an analysis by PricewaterhouseCoopers of previous work by the EURCC's adviser (PwC, 22 September 2010, Review of the Debt Risk Premium Estimates in the

number of observations that appear unusually low (apart from the 'zero' cost of debt for a CitiPower bond). Moreover, this table also omits the utility debt raisings that were undertaken during the worst of the Global Financial Crisis.[57]

Notwithstanding these concerns about the EURCC analysis, Grid Australia considers that a core element of the EURCC proposal – namely that the cost of debt allowance should reflect the embedded cost for an efficiently financed utility – deserves further consideration, while noting that it would require a number of complex issues to be addressed. This matter is discussed further in section 5.2.6.

Turning to the EURCC's proposed approach for determining the benchmark cost of debt at any time, Grid Australia notes that the information presented by EURCC supports the continuation of a 10 year term. While its consultants (CEPA) observed that the remaining term on utility debt is less than 5 years, what is relevant is the term of debt at issue (because that is the time when the cost of the debt is fixed). CEPA's analysis clearly shows that this exceeds 10 years. Moreover, its proposal to broaden the benchmark to include bonds from credit ratings above and beyond BBB+ is not inconsistent with the current practice (and as accepted by the Tribunal). In short, the EURCC analysis does not provide any basis for changing the characteristics of the 'benchmark' in relation to the credit rating and term from what is currently applied.

EURCC proposal for cost of debt to vary based on ownership

Turning to the question of government owned businesses, Grid Australia considers that EURCC's arguments suffer from a number of flaws.

First and foremost, the NEO requires all elements of the regime – including network charges – to promote economic efficiency in the use and production of electricity. However, the EURCC proposal would create lower network charges in states where networks are government owned, thus distorting the locational decisions of major energy users. Specifically, this distortion would arise from more network assets being built than would be the case if energy users were encouraged to locate where it was the lowest cost option.

Secondly, the EURCC proposal ignores the fact that governments only achieve low borrowing costs because of their ability to recover losses that may occur from taxpayers. Accordingly, the total cost caused by government borrowing for an NSP is

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Mountain Report – Letter to United Energy, p.9), which calculated a total rate at the time of issue of 7.25 per cent, 70 basis points higher than what is presented in the EURCC proposal.

[57] The PwC report referred to above reported the interest rates for 9 floating rate debt issues between 10 November 2008 and 5 February 2010, which had an average debt risk premium of 3 per cent for an average term of only 3.6 years.

greater than the direct interest cost, being the sum of the direct interest cost and the risk that is created for taxpayers.

Thirdly, the EURCC proposal would create an artificial bias for governments that own network assets to continue to own those assets, given that a material upward impact on prices would occur if assets were sold. While issues over asset ownership are a matter for governments, it is inappropriate for the form of regulation to create a material distortion to such considerations.

5.2.4 Does the proposal put the right balance on prescription and discretion?

As discussed above, Grid Australia accepts that the Rules at present contain too much prescription with respect to the determination of the cost of debt, and that a widening of the discretion for the AER is appropriate. In addition, Grid Australia considers that the AER should have the ability (but not the requirement) to use a different risk free rate when estimating the cost of equity and debt. The same risk free rate is currently required to be applied when estimating the cost of equity and debt, although there is no compelling reason for this to be prescribed. That said the AER's proposal would provide it with too little guidance with respect to the cost of debt. Grid Australia's preferred approach is addressed in section 5.2.6 below.

More generally, the AER's Rule change proposal has revealed that the Rules contain very little in the way of guidance for the AER when estimating the other WACC parameters (either when reviewing the Statement or making a determination), and that additional prescription is desirable. Grid Australia's views on this matter are also discussed in section 5.2.6 below.

The AER's proposal to remove the 'persuasive evidence' threshold would also remove from the Rules a criterion that requires the AER to consider the stability of its decisions over time, which is a matter that is of substantial importance to investors, while imposing little cost to customers. It has also not prevented the AER from changing a WACC input or method where it considered it appropriate. Removing this clause would remove important prescription from the Rules.

Turning to the EURCC proposal, Grid Australia has noted that it would welcome further consideration of setting the cost of debt with reference to the embedded cost of debt for an efficiently financed NSP. However, it has also noted that this matter would require a number of complex matters to be addressed. Depending on the outcome of that further analysis, if it is decided to pursue such a model then the issue of how much of the model should be reflected in the Rules would need to be determined.

5.2.5 Could existing discretions achieve the same outcomes?

This question in relation to the AER's Rule change proposals has been addressed implicitly against the headings above. In summary:

- Grid Australia acknowledges that the AER is unable to use Australian corporate bonds as the source of information for the debt risk premium.

- The persuasive evidence threshold has not prevented the AER from changing a WACC parameter or method where it has had evidence to do so.

- If elements of the EURCC rule change were to be pursued (that is, using a benchmark embedded cost of debt) then this may require change to other rules. These include the requirement for the rate of return to be a 'forward looking rate of return that is commensurate with prevailing conditions in the market for funds' and the requirement for the cost of debt to 'reflect the current cost of borrowings for comparable debt'.[58] Grid Australia will comment further on these issues if the further analysis of an embedded cost concept suggests it warrants more detailed analysis.

5.2.6 Preferred solution

Cost of debt and other rules guidance

Grid Australia accepts the AER's argument that the current requirement in the rules to infer the cost of debt only from Australian corporate bonds should be removed so that a greater breadth of information could be used if required. However, Grid Australia considers that the important guidance that is contained in the current clause be retained (rather than the clause merely being deleted, as the AER proposed), with this guidance including:

- the cost of debt reflect a benchmark estimate

- the elements of this benchmark be disclosed, including the term and credit rating for the debt, and

- the cost of debt be restricted to the options available to an Australian borrower.

Grid Australia also considers that the rules could separate the estimation of the costs of equity and debt, and so allow a different risk free rate to be used for each.

Grid Australia notes, however, that with the issue of a number of new, long dated Australian corporate bonds, the method that is currently prescribed in the Rules may again be appropriate, and something that the AER could prescribe in the Statement. Provided that the ability to depart from the Statement remained, and the barrier in the current Rules is removed, then any remaining controversy would not be caused by excessive constraints on the AER.[59]

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[58] NER, clauses 6A6.2(j)(1), (2).

[59] It should be noted that when there are few or no transactions upon which to base an estimated yield then some element of controversy will be inevitable.

However, Grid Australia notes that an implication of the AER's proposal was that it highlighted how little guidance the Rules currently provided for the other WACC parameters. As discussed above, in principle, Grid Australia consider that the level of prescription in this regard should be raised. This is required to provide some level of confidence that the basis for setting parameters will be known by investors and relatively stable over time providing a basis for ongoing investment in essential infrastructure. Nevertheless, it is not straightforward to derive principles that would survive events like the Global Financial Crisis. It is noted that the ENA submission sets out some early thinking of the potential further guidance for each of the parameters, which Grid Australia considers should be used as a starting point.

Persuasive evidence threshold

Grid Australia considers that the 'persuasive evidence' threshold should be maintained. The risk posed by new regulatory staff and commissioners looking at substantially the same evidence at successive reviews over time, but coming to materially different conclusions, is material. Reducing this risk would aid the incentive and capacity for investment, while not adversely affecting customers.

Consideration of an embedded cost of debt

As indicated earlier, Grid Australia is open to further consideration of whether the cost of debt should be changed from the current approach, whereby this is set at the spot rate, to one where the cost reflects the embedded cost of debt for a benchmark NSP.

As noted earlier, this change to the regime would be material, and would require a number of issues to be resolved, including:

- How the efficient portfolio was to be defined, which itself would require a view on the form and term of debt. It is noted here, however, that the analysis performed by the EURCC suggests that the current 10 year and BBB+ assumptions remain appropriate.

- How the rate at any point in time would be observed, although again it is noted that the EURCC proposal provides support for the continued use of Australian corporate bonds.

- Whether it should be the cost of debt, or the debt risk premium, that is treated as embedded over time (with the latter added to a spot rate for the risk free rate or swap rate). It is noted that most privately owned businesses enter into interest rate swaps so that the base interest rate is in fact locked into the regulatory period, irrespective of when the debt was raised. In this case, applying an embedded debt risk premium could be more appropriate.

- Whether the cost of debt element should flow through to prices continuously (that is, with an automatic pass through during regulatory period) as the EURCC suggested, or whether the allowance at a price review should be part embedded and part forecast (with the weights reflecting how the benchmark portfolio would be refinanced over time). The EURCC proposal would more closely align the debt allowance with the benchmark cost, but would bring with it additional administrative complexity.

- How the change in approach would affect all parties in light of the NSPs' current debt portfolios that are a function of decisions made under the current approach, which is important to understanding transitional or implementation issues.

- How the change to an embedded cost regime (if desired) should best be given effect in the Rules.

6. Regulatory Decision Making Process

The effectiveness of regulatory procedures for decision making can have a significant influence over the costs and risks associated with regulation. Therefore, Grid Australia supports a framework that allows for the appropriate sharing of information and a procedural framework that encourages timely decision making. This section of the submission addresses the AER's proposals in relation to the regulatory decision making process, namely:

- The ability for network businesses to make submissions during a determination process
- The approach to correcting material errors, and
- The timeframe for the assessment of cost pass through events, contingent projects and capital expenditure reopeners.

6.1 Submissions during a determination process

6.1.1 Overview of Grid Australia position

- It is important for effective regulatory decision making that the AER and third parties are provided with sufficient information to make its decisions
- There are a number of legitimate reasons for network businesses to provide information at times outside of the formal revenue proposal or revised revenue proposal
- The AER proposal is overly prescriptive and restrictive
  - The AER proposal increases the risk of it having insufficient information and therefore regulatory error. This may ultimately lead to an otherwise avoidable use of the appeal mechanisms.
  - The AER already has the discretion to ignore late submissions.

6.1.2 What has the AER proposed and why?

The AER have proposed to restrict network businesses from making a submission on:

- Their own initial proposal
- The AER's draft decision

- Their own revised proposal, and
- On another network business' regulatory or revenue proposal unless there are material differences between the two.

The AER's proposal provides for it to not consider submissions that do not comply with the restrictions or late proposals.

The AER considers that this change is necessary to avoid network businesses constantly putting in late submissions on matters that should be addressed in their proposal or revised proposal. The AER states that late submissions from network businesses restrict the ability for other stakeholders to respond, and for the AER to properly assess further information.

6.1.3 Is there a problem that needs to be addressed?

While Grid Australia agrees that there may be issues associated with information provision, it does not agree with the AER's characterisation of the problem and therefore the proposed solution.

It is recognised that providing substantial information later in a process has consequences on the ability for the AER and third parties to assess information. However, there are a number of legitimate reasons why a network business may need to provide the AER with information outside of the formal proposal or revised proposal, examples include:

- New information may come to hand that is relevant to the determination of capital or operating expenditure. This may include more up-to-date information of actual demand.
- There may be situations where the AER's draft decision is unclear on its reasons or the AER does not publish all the relevant information it has relied upon in reaching its decision. The time taken to seek and receive further clarity and / or the additional information from the AER may impact on the ability to respond to all matters fully in a revised revenue proposal.
- Other stakeholders may raise issues relating to a business' revenue proposal that require a response prior to the AER making a decision on the matter.
- A network business may not consider there is a need to submit a revised proposal but may, nevertheless, wish to comment more generally on the AER's draft decision.

Grid Australia also notes that the existing framework creates some difficulty for network businesses to provide all relevant information in their proposals and revised proposals. This is particularly the case for revised proposals where network businesses only have 30 business days to respond to the AER's draft determination.

This is after the AER has had six months to undertake its analysis and prepare its draft decision. If an issue raised in the AER's draft determination requires a network business to seek additional consulting advice it is very difficult to engage a consultant and have their report completed and understood within the six week window, particularly as this window occurs over the Christmas period for most of the transmission businesses.

6.1.4 Does the proposal put the right balance on prescription and discretion?

Grid Australia considers that the proposal does not provide the right balance between prescription and discretion as it is overly prescriptive and restrictive. As a consequence it limits the ability for the AER to receive information that would assist in its decision making.

Information from the network businesses is a key input into the AER's decision making process. This is because network businesses hold almost all of the cost information associated with running their electricity network. This point was recognised by the Expert Panel which stated:[60]

> *"Under both the building block and total factor productivity control setting methods a regulator must be able to establish the efficient costs of supplying the relevant services for the purpose of delivering prices that reflect those that would be charged by a firm that did not have a substantial degree of market power. Information on the costs incurred in supplying the relevant services is a critical input into this process. Different forms of regulation may then seek to apply outturn cost data in different ways, as explained in Chapter 6, but information on the costs incurred is a common reference point under any form of price control determination process."*

Restricting the ability for network businesses to provide the regulator with robust information or new information as it comes to hand will increase the risk of regulatory error. Errors in regulation can lead to significant costs being incurred, particularly if they are material enough to warrant the use of the merits review process. Indeed, a significant number of the appeals made to the Australian Competition Tribunal have been to rectify errors that the AER have later acknowledged occurred.

An example of the AER refusing to consider relevant late information and the need for the use of the Australian Competition Tribunal can be found with respect to TransGrid. Faced with persistent errors by the AER's advisors regarding maintenance costs, TransGrid sought to present the matter directly to the Board of the AER. This request was refused by the AER. The consequences of the AER not having regard to this late information was an appeal and subsequent decision by the Tribunal in TransGrid's favour (with a requirement for the AER to reinstate around $15 million in forecast operating costs). The need for this costly appeal action could have been avoided had the AER properly considered the information provided.

60 Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy,* April 2006, p.118.

Limiting network businesses to providing information following a draft decision only as part of its revised proposal risks the AER being provided with information that is insufficiently robust or that has not been properly checked for accuracy and relevance. Given the relatively short time-frame for a revised proposal, and the inability to provide further information at a later date, network businesses may need to rush some parts of the analysis that may benefit from further investigation. This means that the quality of information, and the extent it can be relied upon, may be diminished. Again, the major impact in this regard will be on the quality of the AER's decision making.

6.1.5 Could existing discretions achieve the same outcomes?

The existing framework provides sufficient discretion for network businesses to provide relevant information to the AER to inform its decision making. This flexibility means that the network businesses are able to provide the AER with relevant, and robust, information when it is available. Grid Australia notes that the AER has demonstrated a willingness to accept late submissions from non-transmission businesses as well as transmission businesses.[61]

The existing framework also provides that the AER may, but is not required to, consider any submission after the time for making submissions has expired.[62] The capacity for the AER to effectively ignore late submissions puts a discipline on network businesses to comply with formal timeframes for proposals and submissions whenever possible. Given the discretion it already has, it is not clear what benefit can be obtained in prescribing a requirement to ignore a submission when it already has the discretion to do so. Indeed, prescribing a requirement to disregard submissions only increases the risk of regulatory error.

Grid Australia recognises, however, that part of the AER's concerns is likely to be exacerbated by timeframes that do not allow sufficient time, or flexibility, for network businesses to provide all necessary information. As noted above, this is particularly the case with respect to the revised proposal.

6.1.6 Preferred solution

Grid Australia does not consider that the solution proposed by the AER is commensurate with the problem it has identified.

Grid Australia supports the proposed solution in the ENA submission. This solution would involve a process of submissions and cross-submissions on the draft decision and revised revenue proposal. Grid Australia notes that this model is applied by the New Zealand Commerce Commission.

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61 For example, the AER accepted 9 late submissions on Powerlink's Revenue Proposal which extended some 2.5 months beyond the closing date for submissions.

62 Clause 6A12.1 and clause 6A.16(a) of the NER.

Grid Australia also considers that further consideration should be given to extending the timeframe for the revised revenue proposal. Extending this timeframe would ameliorate some of the issues associated with developing a revised proposal over the Christmas period. Bringing forward the timing of the AER draft decision would further assist in meeting timeframes within this period.

In addition, Grid Australia considers that the ability for transmission businesses to provide complete revised revenue proposals within the prescribed timeframe will be supported by ensuring that the AER is required to make all information that supports its draft decision available at the time the draft decision is published.

6.2 Correcting for material errors

6.2.1 Overview of Grid Australia position

- Grid Australia agrees with one aspect of the AER's proposed changes in this area, however, Grid Australia has concerns with the other drafting changes made in relation to the correction of errors in a revenue determination.
  - Grid Australia supports the proposed alignment between the distribution Rules and the transmission Rules regarding the extent that a determination can be corrected for material errors.
  - Grid Australia does not support the proposed drafting change that would allow the AER to 'amend' a determination as it would mean that the part of the determination affected by the error would not be subject to the same type of process and safeguards involved in making the original determination.
  - Grid Australia does not support the proposed drafting change that extends the scope of matters subject to a revocation and substitution of a revenue determination to a 'deficiency' as it provides the AER with discretion considerably in excess of the previous arrangements and significantly increases risk for network businesses.

6.2.2 What has the AER proposed and why?

The AER has proposed a number of changes with respect to the correction of material errors, including that:

- The Rules require all material errors are only corrected to the extent necessary. The AER notes that under chapter 6A of the Rules it may only change the determination to the extent necessary to correct for the error with the exception of errors arising from the provision of false and misleading information. The limitation to only change the determination to the extent necessary does not apply in this instance.

- In the event an error is to be corrected, the AER be afforded the power to 'amend' a revenue determination. The AER considers that it is conceivable there may be circumstances where it is more appropriate or preferable to amend a determination rather than to 'revoke and substitute' the entire determination.
- It be able to amend, in addition to revoke and substitute, a network business' determination where there is a 'deficiency' in the revenue determination or pricing methodology. This change appears to be to align the transmission framework with distribution.

6.2.3 Is there a problem that needs to be addressed?

Grid Australia agrees that it is important to promote certainty regarding the finality of determinations. However, Grid Australia considers that the AER has provided an inconsistent approach on this matter by improving certainty in some areas and inappropriately decreasing it in others.

The AER is presently able to amend a determination more than to the extent necessary when it has been provided with false or misleading information. Grid Australia agrees with the AER that the ability for it to change a determination by more than the extent necessary erodes the certainty and finality of a final determination. In addition, Grid Australia notes that the AER's capacity to vary a determination in areas that are broader than to address the error would nevertheless by limited by the requirement that other parts of the determination maintain consistency with the NEO and revenue and pricing principles.

Grid Australia does not consider that the requirement to revoke and substitute a determination has placed a barrier on the AER such that it requires the option to 'amend' a determination. Section 4.3 of Gilbert and Tobin's report on decision making processes provides a number of examples where the AER has revoked and substituted a determination. These examples demonstrate that the requirement to revoke and substitute a determination has not placed a practical limitation on the AER.

The AER has proposed drafting changes to clause 6A.15 to extend the circumstances when a determination can be amended, revoked and substituted to when there is a 'deficiency'. This proposed change appears to be in order to align the transmission framework with the distribution framework. While there should be consistency between the transmission and distribution framework when it is appropriate to do so, Grid Australia considers that such changes should not be made absent a full consideration of the implications such actions and the differences that already exist between the frameworks.

While the term 'deficiency' exists within the chapter 6 Rules in the context of revoking and substituting a determination, the application of this term is presently constrained by a list of the types of deficiencies that may be corrected. Such a list does not exist for transmission and therefore there is no constraint on the AER's application of the term 'deficiency' in the Rules. This proposed change would therefore create considerable uncertainty for transmission businesses.

6.2.4 Does the proposal put the right balance on prescription and discretion?

On the whole, Grid Australia does not consider the proposal places the right balance between prescription and discretion. While Grid Australia agrees that correcting for errors only to the extent necessary preserves the finality and certainty of the final determination, the other proposed changes of the AER undo much of the certainty and predictability in the existing framework.

The proposal that the AER be able to 'amend' a determination means that those parts of a determination that are amended would not be subject to the same type of process that was involved in making the original determination. Grid Australia notes that the proposal by the AER would have the effect of removing 'amendments' from the scope of matters capable of merits review. This would remove an important safeguard in the current provisions.

The AER's proposed drafting change to include the term 'deficiency' considerably expands the scope for the AER to revoke, substitute or amend a determination. The increased discretion provided to the AER via this change would decrease the certainty and finality of the final determination and in doing so increase risk for network businesses.

6.2.5 Could existing discretions achieve the same outcomes?

Grid Australia accepts that the existing discretion afforded to the AER to correct some existing errors was too broad and increased risk for network businesses. However, the restrictions on the AER to only revoking and substituting a determination, and that this be limited to circumstances when there is false or misleading information or a material error, is appropriate and provides an important safeguard for the businesses. These restrictions preserve the finality and certainty of the final determination except in clear circumstances where the decision needs to be revoked and substituted.

6.2.6 Preferred solution

Grid Australia agrees with the AER's proposed amendment to clause 6A.15(c) to align this with the corresponding provision in Chapter 6 of the Rules. However, for the reasons outlined above Grid Australia does not support the proposed amendments to allow the AER to 'amend' a determination and the extension of its power to revoke and substitute to a circumstance when there is a 'deficiency' in a revenue determination.

6.3 Timeframe for the assessment of cost pass through events, contingent projects and capex reopeners

6.3.1 Overview of Grid Australia position

- Grid Australia agrees that some assessments are complex and may need more time.
- However, the AER proposal may be unduly prescriptive and restrictive.
- Grid Australia endorses the alternative 'stop the clock' provision outlined in the ENA submission as a possible solution noting that other options may also exist to address this issue.

6.3.2 What has the AER proposed and why?

The AER has proposed to make determinations on pass through amounts, contingent projects, and capital expenditure re-openers within 40 days. It has also proposed to have the power to extend the timeframe by an additional 60 days if the assessment involves questions of unusual complexity or difficulty, or the AER requires information further than that submitted by the NSP.

The AER, in giving its rationale for the proposed change, gave a number of examples of natural disasters where there has been considerable time needed to determine the effect of a relevant pass through event. It identified that under the current Rules it is not provided with sufficient flexibility to accommodate such issues of complexity or difficulty.

6.3.3 Is there a problem that needs to be addressed?

Grid Australia agrees that the AER has identified a problem and that some assessments may be particularly complex and require more time for assessment. In particular, Grid Australia agrees that the examples cited by the AER should be subject to longer assessment periods.

6.3.4 Does the proposal put the right balance on prescription and discretion?

Grid Australia considers that the AER proposal does not provide the right balance between prescription and discretion. This is because the proposal does not provide sufficient flexibility to properly assess the events that may require more than a 60 business day delay.

The need to extend an assessment period for a period longer than 100 days may arise in a number of circumstances. For instance, the AER's decision on a cost pass through event may be dependent on the decision of another body, such as a court or another government agency. In this instance, the prescribed timeframes may be insufficient to accommodate these processes.

In addition, there may also be considerable uncertainty about how much time is required to make a decision. Again, if a decision by the AER is dependent on the decision making process of another body, there may, therefore, be some uncertainty about when the relevant information will be made available to the AER. In this circumstance, a hard-wired timeframe may not be able to accommodate such uncertainty.

6.3.5 Could existing discretions achieve the same outcomes?

Grid Australia agrees with the AER that the existing framework does not provide it with sufficient flexibility to accommodate legitimate circumstances where additional decision making time is necessary. However, Grid Australia is concerned that the same issue may arise under the AER's proposal.

6.3.6 Preferred solution

Grid Australia proposes that the AEMC consider alternatives to the 'hard-wired' solution proposed by the AER on this issue. Grid Australia notes that an alternative 'stop the clock' provision is identified in the ENA submission and endorses this as a possible solution, noting that other options may also exist to address this issue..