Australian Energy Market Commission

RULE CHANGE

FINAL POSITION PAPER

National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012

National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012

Rule Proponents

Australian Energy Regulator
Energy Users Rule Change Committee - Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths

15 November 2012

This document represents the AEMC's final position on the network regulation rule change requests. This document is not subject to consultation.

For and on behalf of the Australian Energy Market Commission

Inquiries

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

E: aemc@aemc.gov.au
T: (02) 8296 7800
F: (02) 8296 7899

Reference: ERC0134/ERC0135/GRC0011

Citation

AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 15 November 2012, Sydney

About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two principal functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

Executive Summary

Overview

The Australian Energy Market Commission (AEMC or Commission)[1] will make a series of amendments to the National Electricity Rules (NER) and the National Gas Rules (NGR) in response to the economic regulation of network services rule change requests.

This final position paper sets out the amendments that will be made to the NER and the NGR and the Commission's reasons for these amendments. The purpose of this paper is to inform stakeholders at the earliest possible opportunity of the Commission's position on the rule changes while transitional arrangements to implement the changes are being finalised.

The Commission has extended the timeframe to publish its final rule determination on the rule change requests by two weeks to 29 November 2012 under section 107 of the National Electricity Law (NEL) and section 317 of the National Gas Law (NGL) in order to finalise the transitional arrangements that will be required to implement the amended rules.

The amendments will provide the Australian Energy Regulator (AER), for gas and electricity, and the Economic Regulation Authority (ERA), for gas, with additional strength and flexibility in setting revenues and prices for electricity and gas network service providers (service providers). The most significant changes are in the way the regulator determines the rate of return that service providers can earn on their assets. Other changes relate to how the size of the regulatory asset base (RAB) is determined and the process for making determinations.

The amendments are in response to rule change requests submitted by the AER and a group of large energy users (the Energy Users Rule Change Committee (EURCC)). These requests have been made following one full application by the AER of the current NER to each service provider. The areas covered by the rule change requests are:

- rate of return (under the NER and NGR);[2]
- capital expenditure incentives (under the NER);
- capital and operating expenditure allowances (under the NER); and
- regulatory determination process (under the NER).

In general, the Commission has found that the NER and NGR can be improved and strengthened. The Commission will make a series of changes that will or are likely to

1 In general in this document the term "AEMC" is used in respect of administrative actions or former decisions of the Australian Energy Market Commission, whereas the term "Commission" is used when referring to the considerations and decisions leading up this final position paper.

2 The AER's gas rule change request covers only how the rate of return is set under the NGR. The NGR also apply to the economic regulation of pipeline services in Western Australia. The ERA of Western Australia applies the rules in that State.

contribute to the national electricity objective (NEO) and the national gas objective (NGO) (as relevant) taking into account the revenue and pricing principles.[3]

The amendments comprise a package that, at a general level:

- promote flexibility and adaptability, to allow the regulator to make decisions in changing circumstances, and for service providers with different characteristics, such as network size and geography;
- improve the regulatory determination process to allow the regulator adequate time for decision making, to improve consumer engagement, and to improve transparency and accountability; and
- address ambiguities and clarify provisions, to put beyond doubt the interpretation of certain provisions, particularly in the NER.

Changes to address problems identified

The Commission will make a number of amendments in response to the rule change requests from the AER and the EURCC. These amendments have been informed by numerous submissions from stakeholders, various reports and other material, including the Commission's own analysis. Extensive consultation has been carried out as part of the consideration of these rule change requests. The Commission wishes to express its gratitude for the level of engagement by stakeholders as part of this rule change process.

The Commission's conclusions on the major issues covered are summarised below.

Rate of return

Overall approach

The most significant changes to be made in response to these rule change requests relate to how the rate of return for service providers is determined under the NER and the NGR.

The amendments in relation to the rate of return provisions in the NER and NGR provide for a common framework that enables the regulator to make the best possible estimate of the rate of return at the time a regulatory determination is made. When making the estimate the regulator must take into account the market circumstances, estimation methods, financial models and other relevant information.

Given the capital intensity of energy networks, the rate of return is one of the key determinants of the network prices that consumers pay. The nature of the energy network sector requires service providers to make significant investments in assets over time to maintain and improve their networks. The rate of return allows service providers to attract the necessary funds from capital markets for these investments and service the debt they incur in borrowing the funds.

3 The rule making tests are set out in section 88 of the NEL and section 291 of the NGL. The revenue and pricing principles are set out in section 7A of the NEL and section 24 of the NGL. They set out a number of principles that concern matters such as the recovery of efficient costs, incentives to promote efficiencies and that prices should reflect returns commensurate with the risks involved in providing services.

Common framework

Currently, there are three different frameworks that have varying degrees of flexibility and prescription in how the rate of return should be determined. The Commission has concluded that there are disadvantages with each approach. The rate of return framework for electricity transmission is prescriptive about how the rate of return should be estimated and is not well suited to taking account of changes in market circumstances. The framework for electricity distribution has greater flexibility, but is still relatively prescriptive about how the rate of return should be estimated and varied as circumstances change. The application of the rate of return framework under the NGR has resulted in a similar approach to that taken for electricity, although the framework was intended to allow the approach to estimating the rate of return to better reflect changes in market circumstances.

The AER sought to have one rate of return framework in place, based on the electricity transmission model.

The Commission agrees that there is a strong case for a common framework under the NER, including as between transmission and distribution, and NGR for setting the rate of return. A common framework can minimise risks of distortions in capital allocation or investment decisions between the electricity and gas sectors. Yet, the framework must allow consideration of the different characteristics of service providers in each sector when estimating a rate of return. The Commission does not consider that any of existing frameworks represent the best approach to estimating the rate of return.

The common framework to be implemented requires the regulator to make an estimate of the rate of return that is consistent with an overall objective. The objective is focussed on the rate of return required by a benchmark efficient service provider, with similar risk characteristics as the service provider subject to the decision. Under this approach the regulator has the flexibility to adopt the approach it considers appropriate to estimate the rate of return, provided it considers relevant estimation methods, financial models, market data and other information. This is so that the best estimate of the rate of return can be obtained that reflects efficient financing costs of the service provider at the time of the regulatory determination.

In this way, the regulator can better respond to changing financial market conditions, particularly where volatile market conditions impact on a service provider's ability to attract sufficient capital to finance the expenditure necessary to provide a reliable energy supply to consumers.

Guidelines

While providing for flexibility, the Commission recognises that it is important for investor, service provider and consumer confidence in the framework that the regulator is transparent about its approach, and consults extensively, when determining the allowed rate of return.

To supplement the considerations at each regulatory determination, the new framework requires the regulator to develop rate of return guidelines setting out the approach it intends to take in estimating the allowed rate of return. This must be undertaken no less than every three years and involves consultation with stakeholders. Consultation on the guidelines will give all stakeholders an opportunity to contribute to discussions about how the regulator should approach the overall rate of return estimate.

As part of the framework the Commission has not included any preferred methods for estimating components of the rate of return consistent with the overall objective. Instead the Commission has provided high-level principles to guide the estimation and left the judgement as to the best approach to the regulator to make, consistent with achieving the overall allowed rate of return objective. This involves the regulator making judgements about methodologies, analytical techniques and evidence to use to make the estimate of the rate of return.

Return on debt

As part of its assessment of the rate of return framework, the Commission has found that the estimation of the return on debt component can be improved by allowing consideration of alternative ways of determining the efficient debt servicing costs of electricity network service providers (NSPs).

Both the AER and the EURCC claimed that the current regulatory approach in the NER is not delivering a satisfactory estimate of the cost of debt for NSPs. In its rule change request the EURCC proposed changing the rules from estimating a forward-looking return on debt to using a trailing average of observed historical debt costs of benchmark NSPs.

The Commission agrees with the AER and the EURCC that the current approach in the NER is problematic for some NSPs, depending on their characteristics and debt management strategies. A number of other approaches to estimating the return on debt were suggested to the Commission by stakeholders.

A number of different approaches to estimating the return on debt may meet the overall rate of return objective. Consistent with the new framework, the Commission is of the view that the regulator is in the best position to determine the best methodology to estimating a return on debt. This is consistent with the regulator deciding the characteristics of benchmark efficient firms under the rate of return framework. The regulator may decide there should be more than one definition of a benchmark efficient firm across electricity transmission, distribution and the gas sector.

The common framework to be implemented provides that the regulator can use a range of different methodologies to undertake this task. The rules include factors to which the regulator should have regard when determining the best approach to estimating the return on debt. Amongst those factors is the potential impact on the cost of equity of the approach to estimating the return on debt. For example, if the approach for estimating the return on debt differs materially from the efficient financing approach for a benchmark efficient firm then it may increase the refinancing risk for equity holders. So approaches that minimise this refinancing risk for businesses with particular benchmark efficient characteristics could be passed on to consumers in a cost of equity that is lower than it otherwise would be.

As part of its rule change request, the EURCC proposed that the return on debt for state-owned NSPs to be determined differently from privately-owned NSPs.[4] The Commission has considered this and does not support this aspect of the EURCC’s rule change request. The interest rates that State treasury corporations can secure reflect the credit rating of the relevant state government and not the service provider. If state-owned service providers were to access debt capital markets directly then they would face debt financing costs that reflect their stand-alone credit ratings. If such costs are not reflected in the regulatory framework then investment and resource allocation decisions may be distorted. The Commission considers that the most appropriate benchmark to use in the regulatory framework for all service providers, regardless of ownership, in general is the efficient private sector service provider.

Capital expenditure incentives (electricity)

The Commission will amend the NER to include a number of "tools" that the AER can apply to provide adequate incentives for NSPs to spend capital expenditure efficiently, having regard to an overall capital expenditure objective. The objective describes what the capital expenditure incentive regime, as a whole, should aim to achieve. That is, only capital expenditure that is efficient should enter the RAB to be recovered from consumers in future periods.[5]

The tools will include:

- applying capital expenditure sharing schemes to provide incentives to incur efficient capital expenditure. These are to be designed by the AER;
- undertaking reviews of efficiency of past capital expenditure, including the ability to preclude inefficiently incurred expenditure from being rolled into the RAB; and
- deciding whether to depreciate the RAB using actual or forecast expenditure.

In designing and applying these tools, the AER will be required to take into account a number of principles and factors.

The amendments will include a requirement on the AER to make guidelines setting out its approach to incentives. These guidelines must be made in consultation with stakeholders.

These amendments are in response to the AER’s concerns as well as the Commission's own further analysis. The AER was concerned that there are incentives for NSPs to spend more than the capital expenditure allowances set by the AER as part of their regulatory determinations for a regulatory period. The Commission has identified two key issues with capital expenditure incentives in the NER:

- the power of the incentive to incur capital expenditure efficiently declines during a regulatory period; and

---

4 Note that the term "state-owned" encompasses a variety of terms such as government-owned, and publicly-owned. The term "privately-owned" encompasses a variety of terms such as privately-owned and non-state owned. It is considered that state-owned and privately-owned are the most appropriate and accurate to use and are, therefore, adopted throughout this document.

5 In this context, references to the RAB are to the RAB that is rolled forward from one regulatory period to another.

- capital expenditure above the allowance is not subject to any regulatory scrutiny which means that there is a risk that expenditure above the allowance may be inefficient.

Also, there are factors outside of the NER that may provide for additional expenditure to be incurred.

The Commission has identified a range of potential drivers for spending above a capital expenditure allowance. NSPs exhibit different expenditure practices. There are clearly legitimate circumstances in which expenditure above capital expenditure allowances could occur, but often mitigation action such as reprioritising projects could be taken by the NSP to ensure that, overall, capital expenditure is within the allowance set by the regulator. Amongst some NSPs there is a tendency to defer capital expenditure to the end of the regulatory period. For some this practice is not so obvious. A range of tools (see above) that the AER can apply as appropriate is the best way to address such differences.

As highlighted above, the tools include a review of the efficiency of past capital expenditure coupled with the ability to preclude inefficiently incurred expenditure from being rolled into the RAB. Ex ante incentives are the primary means to reveal the efficient level of capital expenditure. Such incentives are an important part of the overall approach to the treatment of capital expenditure. The introduction of reviews of the efficiency of past capital expenditure should not be seen as diminishing the role of ex ante incentives. Rather, such reviews are to address a gap in the lack of supervision of capital expenditure that *has* occurred. The ability to reduce the capital expenditure rolled into the RAB is intended for obvious cases of inefficiency, and not as the main means of achieving efficient levels of capital expenditure. While the AER can review any past capital expenditure, the ability to reduce the amount to be rolled into the RAB is limited to the amount of expenditure above the capital expenditure allowance.[6]

This ability will apply to capital expenditure incurred in any regulatory year commencing after the first guidelines are finished.

The benefits of a review of the efficiency of past capital expenditure include:

- providing information to other stakeholders regarding the efficiency of the NSP;
- contributing to the AER's analysis in setting capital expenditure allowances for the NSP's next regulatory period; and
- providing a necessary companion to any capital expenditure sharing schemes in place. While effective, capital expenditure sharing schemes may not always provide adequate assurance that capital expenditure is efficient. The review provides a further and final check on the efficiency of capital expenditure forming part of the RAB.

When considered alongside the amendments that will be made to the capital expenditure and operating expenditure allowances outlined below, this package of tools can be used by the AER to provide incentives as required so that only investment that is necessary is incurred and rolled into the RAB. If this occurs consumers will pay

6 Unless it relates to within period capitalisation policy changes or inefficient related party margins, which may also be precluded from being rolled into the RAB.

as part of their network charges only for investment that was necessary to provide reliable network services.

Capital expenditure and operating expenditure allowances (electricity)

The Commission will make amendments to the NER to clarify and remove ambiguities regarding the powers of the AER to interrogate, review and amend capital expenditure and operating expenditure proposals submitted by NSPs. The AER will be required to publish annual benchmarking reports, setting out the relative efficiencies of NSPs based on the information available to it.

These amendments are being made having considered the AER's concerns that restrictions in the NER have resulted in capital expenditure and operating expenditure allowances of NSPs that are not efficient. It should be noted here that what the AER approves in this context is expenditure, not projects.

Increases in the rate of return and expenditure allowances have both been significant factors contributing to higher network charges for consumers, although some increases in expenditure have been necessary.

In clarifying the AER's powers the Commission has confirmed its overall approach to capital expenditure and operating expenditure allowances. The NSP's proposal is necessarily the starting point for the AER to determine a capital expenditure or operating expenditure allowance, as the NSP has the most experience in how its network should be run. Under the NER the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own since it must accept a reasonable proposal. Nonetheless, the AER should determine what is reasonable based on all of the material and submissions before it.

This reflects the obligation that all public decision makers have to justify their decisions. In addition, the NER do not place any restrictions on the analytical techniques that the AER can use to scrutinise and, if necessary, amend or substitute the NSP's capital expenditure or operating expenditure forecasts. From a practical perspective the NER reflect the approaches of other regulators.

The Commission considers that benchmarking is a critical exercise in assessing the efficiency of a NSP and approving its capital expenditure and operating expenditure allowances. Benchmarking should take into account differences in the environments of the different NSPs, being those factors that are outside the control of the NSP. The Commission will remove any potential constraints in the NER on the way the AER may use benchmarking.

Whilst benchmarking is a critical tool for the regulator, it can also be of assistance to consumers, providing them with relative information about network performance on NSPs. Benchmarking information would be useful to consumers when participating in the regulatory determination process and merits reviews, and also in their informal interactions with NSPs.

Regulatory determination process

The Commission will also be making a number of detailed changes to the regulatory determination processes in Chapters 6 and 6A of the NER. Consideration of these rule change requests highlighted the difficulties consumers and their representatives experience in participating in the regulatory determination process.

These amendments follow the consideration of a series of process related issues raised by the AER. Those issues relate largely to the ability of stakeholders to engage effectively in the regulatory determination process.

The Commission considers that the process needs to be transparent and timely. This is so that all parties have a clear understanding of their rights and obligations at the outset, as well as ample opportunity to participate. This is a key contributor to confidence in the overall outcomes from the perspective of both the NSP and consumers.

The changes will include:

- lengthening the regulatory determination process to commence four months earlier, for both electricity distribution and transmission NSPs. This will provide time for the AER to prepare and publish a mandatory issues paper and hold a public forum. It will also provide time for a cross submissions stage later in the process, if required;
- the application of an optional framework and approach paper as part of the electricity transmission and distribution regulatory determinations processes. This document can be used, where necessary, to settle a number of issues prior to regulatory proposals being submitted. Examples include information that needs to be provided by the NSP, and the capital expenditure incentive package that the AER proposes to apply to the NSP; and
- improving transparency and accountability by requiring NSPs to nominate to the AER the reasons why it classifies material as confidential. The AER will be required to publish a report of the NSP making confidentiality claims as well as indicating the proportion of material that the NSP claims to be confidential.

The Commission considers that the consultation process in the regulatory determination process that will apply in the NER is the minimum that would be required. The Commission encourages greater engagement and interaction between the NSP and consumer representative groups, and the NSP and the AER outside of the formal regulatory determination process set out in the NER.

Differences between draft rule and final position rule

The Commission has published a version of the final position rule that reflects its conclusions and decisions as contained in this final position paper (the final position rule). The Commission will make and publish the final rules with the final rule determination by 29 November 2012.

While the final position rule substantially reflects the draft rule, there are some changes. Key differences include:

- clarification of the drafting of the return on debt factors;
- in respect of precluding any capital expenditure from being rolled into the RAB for overspends, it may only be applied for capital expenditure undertaken in

regulatory years that commence after the capital expenditure incentive guidelines have been published;

- the powers of the AER to interrogate and amend expenditure proposals have been further clarified (clauses 6.12.3(f) and 6A.13.2(a) have been deleted entirely);
- the obligation on NSPs to comply with AER expenditure forecasting methodologies has been adjusted so that NSPs may instead provide expenditure assessment information required by the AER separate to their regulatory proposal;
- the new regulatory process has been shortened by two months (meaning it will only be four, rather than six months, longer than at present);
- the framework and approach process may be triggered by a NSP and not just by the AER; and
- the contingent project threshold has been changed to $30 million or 5% of the annual revenue requirement / maximum allowed revenue (whichever is higher).

Consumer engagement and participation

A number of the amendments that will be made also attempt to address a lack of focus on consumer engagement and participation. The changes in this regard will be broad and varied.

They will include requiring:

- the NSP to indicate in its regulatory proposal the extent to which it has engaged with consumer representatives. The NSP must also include an overview paper in its proposal for consumers;
- the AER to publish an issues paper after receiving the regulatory proposal. The purpose of this paper will be to assist consumer representative groups to focus on the key preliminary issues on which they should engage and comment;
- the AER to publish a benchmarking report that informs consumers on the relative efficiencies of NSPs; and
- the AER, when determining the capital expenditure and operating expenditure allowances, to take into account the extent to which the NSP has engaged with consumers in preparing its forecasts.

Drivers for effective regulation

The Commission is of the view that the package of amendments to be made to the NER and NGR provides the regulator with additional tools to carry out its functions. The effectiveness of the NER and the NGR in terms of the overall price and service outcomes experienced by consumers is dependent on two drivers:

- the effective application of the NER and NGR by the regulator and review body; and

- the effective corporate governance of the NSPs providing services which are subject to economic regulation.[7]

The efficiency with which network services are provided depends on the way in which the drivers work together. Only when these aspects are operating as intended will the best outcomes for consumers be achieved.

The interpretation and application of the rules by the regulator is crucial. This final position paper provides examples and illustrations of how the rules could be interpreted and applied to address problems that exist currently, but also how their application could adapt when the circumstances change. The same guidance will be included in the final rule determination with the final rule as made. We discuss in the next section the role of merits review in effective application of the NER and NGR.

Management and shareholders of service providers also play a critical role in the efficient provision of network services. They do this through a variety of means, such as approving proposals to be submitted to the regulator, given the significance of AER decisions for these businesses. They also create incentives within the business to encourage efficient outcomes.

Merits review

While the Commission has been considering these rule change requests the Standing Council on Energy and Resources (SCER) decided to bring forward the review of the Limited Merits Review (LMR) regime in the NEL and the NGL. In April 2012 a panel was appointed to undertake the review. On 9 October 2012 the panel published its final stage two report.

The LMR Panel has observed that a narrower, and more formalistic approach to merits review has developed than what was originally intended. In its view this approach has been relatively detached from:

- the focus on the overall objectives set out in the NEL and NGL; and
- encouraging outcomes that are in the long term interests of consumers.

The LMR Panel has proposed in its final stage two report that the NER and the NGR could be amended to clarify that decisions under those rules should be more holistic and broader, focussing on overall outcomes rather than component elements.

The recommendations in the final stage two report that seek to encourage a greater focus on objectives and overall outcomes are consistent with the final position in this rule change and are supported by the Commission. Where possible, the final position rule seeks to allow and encourage the regulator to approach decision-making more holistically to meet overall objectives consistent with the NEO, NGO and RPPs. In line with this overall approach, the Commission is supportive of the review body being constituted, empowered, staffed and resourced in such a way as to be able to take the same holistic approach to the review of decision-making.

The Commission supports the need for accountability of the regulator through some form of merits review. Outcomes for consumers are likely to be improved if the

7 Corporate governance here refers to governance at both the management and shareholder level.

proposed changes in the LMR Panel report to encourage a greater focus on objectives and overall outcomes by the review body are implemented. However, this final position paper and the final position rule proceed on the basis of the merits review arrangements existing at this point in time. As noted by the LMR Panel final report, to the extent that the merits review arrangements change, there may also need to be further rule changes to align the rules with the changes to the NEL and NGL regarding issues such as the definition of a reviewable decision.

Next steps

This final position paper and the final position rule is not subject to consultation.

The final rule determination and the final rule will be published by 29 November 2012 and will include the reasons set out in this final position paper and the transitional arrangements for the implementation of the final rules.

Contents

1 Introduction

1.1 Purpose of this final position paper

On 15 November 2012, the Commission issued notices under section 107 of the NEL and section 317 of the NGL to extend the timeframe for making its final rule determination in relation to the network regulation rule change requests (discussed below) in order to allow for additional consultation and analysis on transitional arrangements for its implementation.

This document reflects the final position of the Commission in relation to each of the matters raised in the rule change requests. It is intended to inform stakeholders at the earliest possible opportunity of the Commission's position in response to consultation on the draft rule determination while transitional arrangements to implement the changes are being finalised. It does not include any discussion on transitional arrangements, including the publishing requirements for first guidelines. These issues will be addressed in the final rule determination.

The Commission has also published a version of the final position rule that reflects its conclusions and decisions as contained in this final position paper. The Commission will make and publish the final rules with the final rule determination by 29 November 2012.

1.2 Rule change requests

In September 2011 the Australian Energy Regulator (AER) submitted two rule change requests seeking to amend the rules for the economic regulation of network services. The areas identified by the AER as deficient and requiring improvement are:

- For electricity: the capital and operating expenditure framework, capital expenditure incentives, rate of return provisions and the efficiency of the regulatory process, as set out in the National Electricity Rules (NER); and
- For natural gas: the rate of return provisions in the National Gas Rules (NGR).

In October 2011, the Energy Users Rule Change Committee (EURCC), a committee of large energy consumers, comprising Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths, also submitted a rule change request. The EURCC's rule change request relates to one area of the rate of return on capital under the NER, being the cost of debt. The EURCC sought changes to the NER relating to the methodology for the calculation of the return on debt component and a differential cost of debt for state-owned and privately-owned network service providers (NSPs).[8]

1.3 Rationale for the rule change requests

This section sets out, at a high level, the major problems with the current NER and NGR, as reflected in the AER's and the EURCC's rule change requests.

8 In this final position paper a reference to "service providers" includes both gas and electricity service providers, while a reference to "NSP" refers only to an electricity network service provider.

In the AER's view, the rules, in particular the NER, have hindered its ability to appropriately regulate the electricity networks, to ensure that the regulated electricity networks invest efficiently and earn appropriate commercial returns, and to respond to changing circumstances.[9] These conclusions have followed at least one application of the Chapter 6 and Chapter 6A NER frameworks for each of the electricity NSPs, and the equivalent provisions of the NGR for gas service providers. The main problems identified by the AER are as follows:

- capital expenditure and operating expenditure allowances (electricity) – the AER referred to restrictions under the NER on its ability to interrogate and amend the capital expenditure (capex) and operating expenditure (opex) forecasts of NSPs and the requirement that the regulator must accept a forecast if it reasonably reflects certain criteria listed in the NER. The AER considered that the NER invite upwardly biased forecasts and limit its ability to interrogate and amend forecasts provided by NSPs;
- capex incentives (electricity) – the AER considered that there are problems with the current NER in respect of capex incentives. This is because they provide for all actual capex incurred within a regulatory control period to be rolled into the regulatory asset base (RAB) regardless of whether or not the capex allowed for in the determination was efficient. This roll forward model, in the AER's view, creates incentives for NSPs to incur more than efficient levels of capex;
- rate of return (electricity and gas) – the AER's electricity and gas rule change requests referred to the problems associated with having different rate of return frameworks for electricity distribution, electricity transmission and gas. In the AER's view these frameworks have required repeated assessments of similar arrangements and evidence for each determination or access arrangement process, creating an administrative burden. For gas, the AER stated that the NGR create uncertainty in that they do not specify a particular framework for determining the rate of return;
- cost of debt (electricity and gas) – the AER stated that the current approach to assessing the cost of debt has become difficult to apply under changing financial market conditions. The EURCC also considers this approach is problematic in the case of electricity, along with the lack of a differential cost of debt for state-owned and privately-owned NSPs; and
- regulatory determination process (electricity) – the AER has raised a number of process issues that largely concern the ability of stakeholders to engage effectively in the regulatory determination process. For example, NSPs provide submissions on their own regulatory proposals. In the AER's view this may result in stakeholders having insufficient time to consider additional material from the NSP.

9 AER Executive Briefing, 29 September 2011, p. 1.

1.4 Solutions proposed in the rule change requests

The rule proponents proposed a number of amendments to the NER and the NGR to address the problems they have identified. In short, the solutions may be described as follows:

- capex and opex allowances – the AER proposed amendments to the NER to set its own estimate of capex and opex, using a range of inputs;
- capex incentives – the AER proposed for inclusion in the NER a sharing mechanism that would apply to any expenditure above the regulatory allowance. 60 per cent of this expenditure above the allowance would be rolled into the RAB for the next regulatory control period, with the remainder excluded from that asset base and funded by shareholders. It also proposed being given the discretion in transmission to determine whether to adopt forecast or actual depreciation; and to disallow capex for related party margins and as a consequence of capitalisation policy changes;
- rate of return – the AER proposed a single framework for electricity and gas which most closely aligns with the current framework for electricity transmission set out in Chapter 6A of the NER; that is, the outcomes of periodic rate of return reviews must apply and cannot be departed from in subsequent determinations and access arrangements made before the next rate of return review. The AER would also amend the NER and the NGR to provide it with increased discretion in how to determine certain individual parameters forming part of the rate of return and would remove the need for persuasive evidence before amending them. For gas in particular, the AER proposed that the NGR would prescribe that the rate of return would be calculated as a nominal post-tax vanilla weighted average cost of capital, using the capital asset pricing model to determine the return on equity. This means the rate of return provisions for electricity and gas would be in line;
- cost of debt - the AER proposed that the methodology for setting the debt risk premium should be included in the periodic rate of return reviews undertaken by the AER, rather than being prescribed in the NER. The EURCC proposes a new rules-prescribed methodology for calculating the cost of debt, having regard to the "actual debt costs" of electricity NSPs. The return on debt for state-owned electricity NSPs would be determined differently to non-state owned NSPs; and
- regulatory determination process - the AER considered that aspects of the current regulatory determination process under the NER could be improved to enable more timely submission and consideration of material by all relevant stakeholders prior to the AER making its decisions.

1.5 Consultants

The Commission) has engaged a number of consultants to assist it with the analysis of issues raised in the rule change requests from the AER and the EURCC. These consultants have provided reports to the AEMC which are available on the AEMC’s website.

Over the course of the rule change process the AEMC engaged the following consultants to undertake analysis and provide reports:

- Professor Stephen Littlechild, Professor George Yarrow - assistance in the area of capex and opex allowances, capex incentive and regulatory process;
- Strategic Finance Group Consulting (SFG) - assistance on the rate of return including a specific report return on debt methodologies and advice on issues raised in the draft rule determination.
- The Brattle Group (Brattle) – on approaches to assessing capex and opex forecasts;
- Covec - on related party margins;
- Economic Insights – on the use of actual and forecast depreciation; and
- Parsons Brinckerhoff – on capital expenditure practices of NSPs.

These reports of these consultants have been published on the AEMC's website.

In reaching its final position on the rule change requests, the Commission has been informed by the material prepared by these consultants.

1.6 Commencement of rule making process and extensions of time

On 20 October 2011, the Commission published a notice under section 95 of the NEL and section 303 of the NGL advising of its intention to commence the rule making processes and first round of consultation on the AER's rule change requests. A consultation paper prepared by AEMC staff identifying specific issues and questions for consultation was also published with the rule change requests.

Given that the proposals raised issues in the rules on similar subject matter, on 3 November 2011, the AEMC gave notice under section 93(1)(a) of the NEL to consolidate the EURCC's rule change request with the AER's electricity rule change request. The result of this consolidation was the creation of a new consolidated rule change request which would run to the same process and timetable as the original AER rule change request.

Due to the complex nature of these rule change requests, the AEMC issued notices under section 107 of the NEL and section 317 of the NGL to extend the length of the rule change process in this case. Accordingly, on 20 October 2011 and 3 November 2011, the AEMC issued notices to extend the period of time for the making of the draft rule determinations on these rule change requests to 26 July 2012. On 21 June 2012, the AEMC issued further notices under section 107 of the NEL and section 317 of the NGL to extend the period of time for the making of the draft rule determinations to 23 August 2012.

The AEMC has issued a notice with this final position paper on 15 November 2012 under section 107 of the NEL and section 317 of the NGL to extend he period of time for the making of the final rule determinations to 29 November 2012.

1.7 Consultation on rule change requests

On 20 October 2011 the AEMC issued a consultation paper on the AER rule change request and on 3 November 2011 it issued a consultation paper on the EURCC rule change request. The AEMC held a public forum in Brisbane on 23 November 2011 to facilitate discussion on the - rule change requests. Submissions on the two consultation papers closed on 8 December 2011.

On 2 March 2012, the AEMC published a directions paper on the consolidated rule change request and the AER's gas rule change request.[10] The directions paper explained the AEMC's initial positions on, and set out its next steps to progress these rule changes requests. A series of workshops were also held on 2 April 2012 in Melbourne to discuss some of the key issues raised in the directions paper. Submissions on the directions paper closed on 16 April 2012. A summary of these submissions is published on the AEMC's website.

The AEMC held a public forum in Sydney on 9 May 2012 with Professors Littlechild and Yarrow. Professors Littlechild and Yarrow presented on the papers they provided for the AEMC's directions paper, which provided stakeholders with the opportunity to raise questions with them.

The AEMC held workshops in Sydney on 18 May 2012 and 13 July 2012 on cost of debt issues. The AEMC also invited written submissions on cost of debt issues which closed on 5 July 2012.

On 23 August 2012 the AEMC published its draft rule determination and draft rules. Submissions on the draft rule determination and draft rules closed on 4 October 2012. A summary of these submissions is published with this final position paper.

On 14 September 2012 the AEMC published a consultation paper on transitional issues and then on 25 September it published consultation rules on transitional issues. On 26 September 2012 a workshop on transitional issues was held.

This document represents the Commission's final position of the network rule change requests. This document is not subject to consultation.

10 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012.

2 Commission's reasons

2.1 Introduction

A number of problems have been raised in the rule change requests. They have been considered against submissions, various reports and other material, and the Commission's own analysis. The Commission has concluded that there are problems in the NER and, in the case of rate of return, the NGR, and rule changes are required to address those problems.

The solutions set out in this final position paper and included in the final position rule are a positive contribution to the overall effectiveness of the economic regulation of network services generally under Chapters 6 and 6A of the NER, and the application of the rate of return under the NGR. They comprise a package of changes that, at a general level:

- promote flexibility and adaptability, enabling the regulator to make decisions in changing circumstances, and for service providers with different characteristics;
- improve the regulatory determination process to allow the regulator adequate time for decision-making, to improve consumer engagement, and to improve transparency and accountability; and
- address ambiguities and clarify provisions, to put beyond doubt the interpretation of provisions, particularly in the NER.

The Commission's detailed analysis and consideration of issues is contained in the subsequent chapters. This chapter sets out the Commission's analysis and articulation of the problems and amendments to the NER and NGR at a high level.

2.2 Summary of assessment of issues

The rule change requests raised four broad areas of problems with the rules, as set out in section 1.3 above. Taking each in turn, the Commission draws the following conclusions as set out below.

2.2.1 Rate of return

Overall framework

The AER referred to problems associated with having different rate of return frameworks for electricity distribution, electricity transmission and gas. It sought to have one rate of return framework put in place, based on the electricity transmission model. The Commission's initial views were that the current rate of return rules for electricity transmission are not satisfactory as they do not provide sufficient flexibility to deal with changing circumstances. Having undertaken considerable analysis in this area, the Commission has concluded that none of the existing rate of return frameworks under the NER and NGR has the characteristics necessary to best meet the NEO and NGO, taking account of the Revenue and Pricing Principles (RPP).

There is a strong case for a common framework under the NER, including as between transmission and distribution, and NGR for setting the rate of return. A common framework can minimise any risks of distortions in capital allocation or investment decisions between the electricity and gas sectors, although the framework contemplated here would provide scope for the regulator to consider the different characteristics of NSPs in each sector when determining a rate of return for each NSP.[11]

Under the new approach the regulator must determine a rate of return (the allowed rate of return) that is consistent with that required by a benchmark efficient firm with similar risk characteristics to the service provider in question. A key feature of the new framework is that the allowed rate of return is effectively determined on a "determination by determination basis".[12] This will enable the regulator to better respond to changing financial market conditions, particularly where volatile market conditions impact on a NSP's ability to attract sufficient capital to finance its expenditure requirements.

While providing for flexibility, the Commission recognises that it is important for investor, NSP and consumer confidence in the framework that the regulator is transparent about its approach to determining the allowed rate of return. Further, it is also important that all stakeholders should have an opportunity to contribute to discussions about how the regulator will determine the overall rate of return, including how it will estimate the return on equity and debt components of the overall allowed rate of return.

To supplement the considerations at each determination, the new rate of return framework requires the regulator to develop rate of return guidelines that set out the approach it intends to take to estimating the allowed rate of return for NSPs. These guidelines must be reviewed at least every three years. This will allow all stakeholders to periodically consider and comment on new evidence or analytical techniques that may allow better estimates of the rate of return to be made. This process should provide a smooth evolutionary process for estimation techniques to develop as new evidence and thinking emerges.

The effectiveness of the Commission's proposed framework for the determination of the allowed rate of return depends, to a significant degree, on how the regulators and the appeal body interpret the new rules. The Commission has taken the opportunity in this final position paper to explain how the new rules are to be interpreted. Most importantly, the new rules allow the regulator (and the appeal body) to focus on whether the overall rate of return meets the allowed rate of return objective, which is intended to be consistent with the NEO and NGO and RPP.

The Commission has not included in the new rules any preferred methods for determining a rate of return consistent with this objective, but instead has left the judgement as to the best approach to the regulator to make consistent with achieving that objective.

---

11 In this chapter of the document, the term "NSP (network service provider)" is used to refer generally to electricity network service providers under the NER and gas service providers under the NGR, unless the context requires otherwise.

12 In this document generally, in the context of the rate of return, the term "determination" refers both to regulatory determinations under the NER and access arrangement determinations under the NGR.

Return on debt

As part of its assessment of the rate of return framework, the Commission has found that the estimation of the return on debt component can be dramatically improved to allow consideration of alternative ways of determining the efficient debt servicing costs of electricity NSPs.

Both the AER and the EURCC have claimed that the current regulatory approach in the NER is not delivering a satisfactory estimate of the cost of debt for NSPs. In its rule change request the EURCC proposed changing the rules from estimating a forward-looking return on debt to using a trailing average of observed historical debt costs of benchmark NSPs.

The Commission agrees with the AER and the EURCC that the existing approach in the NER is problematic for some NSPs, depending on their characteristics and debt management strategies. A number of other approaches to estimating the return on debt were suggested to the Commission by stakeholders.

A number of different approaches to estimating the return on debt may meet the overall rate of return objective. Consistent with the new rate of return framework, the Commission is of the view that the regulator is in the best position to determine the best approach to estimating a return on debt for different types of service providers. The new rule gives the regulator the ability to use a range of different approaches to undertake this task.

As part of its rule change request, the EURCC also argued for the return on debt for state-owned NSPs to be determined differently from privately-owned NSPs. The Commission has considered this proposal in detail and has concluded that it would be inappropriate for the rules to make such a distinction. The Commission maintains its view that the EURCC's arguments in support of its proposal are misplaced, and ignore the competitive neutrality principles that apply to state-owned NSPs.

2.2.2 Capital expenditure and operating expenditure allowances and related issues

Capex and opex allowances

This first issue concerns the ability of the AER to interrogate and amend capex and opex proposals. The AER stated that restrictions in the rules have resulted in capex and opex allowances forming part of determinations for NSPs that are higher than they should be. Since publication of the directions paper the Commission has undertaken further work to assess this issue from two perspectives – analysing any further evidence provided to it of the drivers of prices, as well as engaging consultants to reconsider the original approach to expenditure allowances in Chapter 6A of the NER, dealing with the economic regulation of electricity transmission services. From this the Commission has concluded:

- increases in the rate of return and expenditure allowances have both been significant factors contributing to higher network charges; and some increases in expenditure have been necessary. On the basis of information provided to the Commission it is not possible to tell if constraints on the AER's ability to amend

NSPs' expenditure forecasts have caused inefficient increases in expenditure allowances; and

- from a practical perspective the approach in respect of expenditure allowances in Chapter 6A of the NER reflects the approach of regulators in other jurisdictions in Australia and overseas. There are, however, some areas for improvement in the NER, largely to clarify that approach, and to remove any ambiguities.

The Commission remains of the view that the essential features of the capex and opex allowances provisions in the NER are appropriate. The NSP's proposal is necessarily the starting point for the AER to determine a capex or opex allowance, as the NSP has the most experience in how its network should be run. Under the NER the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own since it must accept a reasonable proposal. But the AER should determine what is reasonable based on all of the material and submissions before it. This reflects the obligation that all public decision makers have to justify their decisions. In addition, the NER do not place any restrictions on the analytical techniques that the AER can use to scrutinise and, if necessary, amend or substitute the NSP's capex or opex forecasts.

Having confirmed that base, the Commission has identified some provisions that may be causing constraints in an unintended way, particularly clause 6.12.3(f). As a result, it determined to remove the clause.

The Commission views benchmarking as a critical exercise in assessing the efficiency of a NSP and in approving capex and opex allowances. Benchmarking should take into account differences in the environments of the different NSPs, being those factors that are outside the control of the NSP. The Commission has removed any potential constraints in the NER on the way the AER may use benchmarking.

Annual benchmarking report

One of the problems associated with the current regulatory determination process is the difficulties consumers and their representatives experience in participating effectively. The final position rule includes a number of provisions designed to improve the ability of consumers to participate in the regulatory determination process, a number of which are considered below. Whilst benchmarking is of critical importance to the regulator, it can also be of assistance to consumers, providing them with relative information about network performance. This would be useful to consumers when participating in the regulatory determination process and merits reviews, but also in their informal interactions with NSPs. On this basis the AER should publish annual benchmarking reports, setting out the relative efficiencies of distribution network service providers (DNSPs) and transmission network service providers (TNSPs), taking into account the exogenous factors that distinguish them.

Other issues

The rule change requests and further submissions have raised other issues relating to:

- increased consultation on expenditure models – the AER will be required to publish expenditure forecast assessment guidelines and determine how it will be applied at the framework and approach paper stage, which will also apply to

TNSPs, see below and section 8.4.3. NSPs will be required to submit complying information with their regulatory proposals. In addition, NSPs are to advise the AER of their approach to preparing expenditure forecasts at the framework and approach stage. This will encourage stakeholders to discuss the model at an earlier stage and before proposals are submitted; and

- capex and opex factors – the AER must have regard to the capex and opex factors when assessing capex and opex proposals. The process-related aspects of these factors are more appropriately located elsewhere as they are of a different character to the other factors in that they deal with the materials presented to or obtained by the AER in the course of the regulatory process. Further changes to the capex and opex factors are necessary to address a variety of incidental issues such as to take into account the various incentive schemes provided for in the NER. Finally, a factor has been included to require the AER to have regard to the extent to which NSPs have considered what consumers seek. The more confident the AER can be that consumers' concerns have been taken into account, the more likely the AER can be satisfied that a proposal reflects efficient costs.

2.2.3 Capex incentives

Sharing schemes, reviews and depreciation

The AER raised concerns about what it considers to be incentives for NSPs to spend more than efficient levels of capex, that is, above the capex allowances made as part of their determinations, for a regulatory period. To address this problem in its rule change request, the AER recommended the introduction of a requirement in the NER that only 60% of any expenditure incurred by a NSP above its capex allowance would be rolled into the RAB and, therefore, be recoverable. Related to this the AER also requested that it be given the discretion to roll forward the RAB using depreciation based on actual or forecast expenditure.

After undertaking initial analysis, the Commission concluded that the NER does not provide incentives for NSPs to spend more than their allowance, although factors outside the NER may provide for such additional expenditure. The Commission did identify two key issues with capex incentives in the NER:

- the powers of the incentive not to incur expenditure above capex allowance declines during a regulatory period, which has implications for efficiency incentives, timing of capex and substitution between capex and opex; and
- capex above the allowance is not subject to any regulatory scrutiny which means that there is a risk that expenditure above the allowance may be inefficient.

Following the directions paper the Commission undertook further analysis of actual capex by NSPs; engaging consultants to assist. Both the work of the consultants and the Commission's own analysis have identified a range of theoretical drivers as to why a NSP might spend more than its capex allowance. The consultants also identified different expenditure practices of NSPs. There are clearly legitimate circumstances in which expenditure above capex allowances could occur, but often mitigation action could be taken so that, overall, capex is within the allowance. Amongst some NSPs there is a tendency to defer capex to the end of the regulatory period. For some this practice is not so obvious.

Given the problems identified and the results of the further analysis, the Commission's approach is to provide the AER with a number of "tools" that it can apply as it considers necessary to provide adequate incentives on NSPs to spend capex efficiently, having regard to an overall capex objective and consistent with the NEO and RPP. The tools are: capex sharing schemes to be designed by the AER, efficiency reviews of past capex and deciding whether to depreciate the RAB using actual or forecast expenditure to establish a NSP's opening RAB. This package should also be viewed alongside the ability of the AER, on an ex ante basis, to scrutinise effectively, and if necessary amend, proposed capex allowances as part of the determination process so that allowances set in the first place are efficient.

An overall capex incentive objective will describe what the capex incentive regime, as a whole, should aim to achieve – both in respect of the guideline that the AER must make setting out its proposed approach to application of the capex incentive "tools" provided in the NER and how it applies a capex incentive regime to an individual NSP. The AER will also be required to take into account a number of principles and factors when designing and applying the capex tools.

Regarding the reviews of the efficiency of past capex, the Commission is of the view that this is the most appropriate way to address the lack of supervision of incurred capex. Such a review is also a necessary companion to any capex sharing schemes in place. While effective, capex sharing schemes will not necessarily mean that capex incurred is efficient. A further and final check on the efficiency of expenditure that is rolled into the RAB is in the long term interests of consumers.

The AER may use the analytical techniques it considers appropriate to undertake such reviews, in much the same way as it can when assessing capex proposals. The AER will be required to undertake a review of the efficiency of past capex for all NSPs as part of the determination process and include a statement on the efficiency of expenditure going into the RAB. The AER will also have the discretion to preclude inefficient past capex being rolled into the RAB to the extent of any over expenditure above the capex allowance for the previous regulatory period. This discretion should not be seen as diminishing the role of ex ante incentives. Rather, such reviews are to address a gap in the lack of supervision of capital expenditure that has occurred. The ability to reduce the capital expenditure rolled into the RAB is intended for obvious cases of inefficiency, and not as the main means of achieving efficient levels of capital expenditure.

Related party margins and capitalisation policy changes

In addition to the broader capex incentive issue discussed above, the AER considers that there are two additional capex incentive issues in the NER relating to related party margins and changes to capitalisation policies during a regulatory period.

Work undertaken (including modelling undertaken by consultants) appears to confirm that there is a potential incentive for NSPs to incur inefficient related party margins, even with capex sharing schemes in place. This incentive could encourage NSPs to enter into commercial arrangements that are not the most efficient. The Commission considers that the issue should be dealt with by reviewing the capex after it is undertaken. Therefore the Commission will give the AER discretion to preclude inefficient related party margins being rolled into the RAB, regardless of whether the NSP spent more than its allowance overall. In assessing this type of expenditure, the AER should take a flexible approach, recognising the differing incentive power in different circumstances.

The Commission accepts that there is a potential incentive for a NSP to change its capitalisation policy so that it can classify opex as capex and recover the same expenditure twice: once in forecast opex; and again through depreciation and return on capital once the expenditure is rolled into the RAB. The strength of such an incentive would be affected by other factors, such as the requirements of statutory accounting and capex sharing schemes. Ex ante incentives will not necessarily deal with the issue, however, so the AER should be able to review the relevant capex after it is incurred.

Similar to related party margins, the Commission proposes to give the AER discretion to preclude expenditure being rolled into the RAB to the extent that expenditure reflects operating expenditure that was capitalised as a result of changes to the NSP's capitalisation policy during the regulatory period. The AER should have this discretion regardless of whether the NSP has spent more than its allowance overall or not.

2.2.4 Regulatory determination process

Steps in the process

The AER raised a series of process-related issues, largely relating to the submission of material by NSPs late in the regulatory determination process. The AER's concern in this regard was that there is inadequate time to review and comment on this material, both from the AER's and other stakeholders' perspectives. The Commission has reconsidered the regulatory determination process as set out in the NER, under both Chapters 6 and 6A. This has been undertaken taking into account other aspects of the consolidated rule change request. Also relevant is, on the one hand, the need for the regulator and other stakeholders to have adequate time to consider and respond to material and, on the other hand, the need in some circumstances for material to be submitted later in the process.

A number of detailed changes have been made to address these issues, with a view that the regulatory determination process needs to be transparent and timely to ensure that all parties have a clear understanding of their rights and obligations at the outset, as well as ample opportunity to participate. This is a key contributor to confidence in the overall outcomes from both the perspective of the NSP and consumers. The changes include:

- lengthening the regulatory determination process by four months, for both electricity distribution and transmission. This provides for time for the regulator to prepare and publish an issues paper as well as time for a cross submissions stage later in the process if required;
- the application of an optional framework and approach paper for electricity transmission as well as distribution. Also that documents can be used, where necessary, to settle a number of issues prior to regulatory proposals being submitted. Examples here include information that needs to be provided by the

NSP, and the capex incentive package that the AER proposes to apply to the NSP; and

- improving transparency and accountability by requiring NSPs to identify specific confidentiality claims in their regulatory proposals and the AER to report on such claims and also late or out-of-scope material from NSPs.

Some of these changes should also improve the ability of consumers to participate in the regulatory determination process.

It is important to note that the Commission considers the regulatory determination process set out in the NER as a minimum. The Commission encourages engagement and interaction between NSPs and consumers, and the AER and NSPs outside of the formal processes.

Diverse issues

The AER raised a number of diverse issues. Firstly, the AER proposed a broader uncertainty regime in distribution to balance its proposals for stronger capex incentives and more discretion in respect of capex and opex allowances, including defining the materiality threshold for cost pass through events. Secondly, the AER proposed to align and extend the timeframes for it to make decisions on applications under the uncertainty regime for distribution and transmission. Thirdly, the AER proposed to broaden the type of material errors or deficiencies by which the AER could revoke and substitute a regulatory determination and also be able to amend the regulatory determination. Fourthly, the AER proposed to introduce a shared assets mechanism to allow it to decide on whether to apply a revenue adjustment or control mechanism adjustment for assets which are shared for services related to standard control and other services. Finally, the AER proposed for it to be given the ability to create incentive schemes outside of those prescribed in the NER.

The general approach the Commission took with these particular proposals was, where they were adopted, to seek to achieve consistency between Chapters 6 and 6A unless there are substantive reasons for a difference. In respect of the AER's proposals, the Commission has decided as follows:

- for increased accountability on the NSP and to allow the NSP to recover efficient costs for unexpected events, the capex reopener and contingent project regimes that apply in transmission will now also apply in distribution;
- to build in flexibility, the decision-making timeframe for applications under the uncertainty regime will be extended for complex or difficult issues;
- the AER's power to revoke and substitute a decision for a material error or deficiency under Chapter 6A will be limited as currently provided under Chapter 6;
- to promote innovation whilst also providing for cost reflectivity to consumers, a shared assets cost adjustment mechanism may apply to assets that share standard control services or prescribed transmission services with any unregulated services; and

- to promote innovation and flexibility, the AER will be able to develop small scale pilot or test schemes to ensure that the potential impact of such a scheme is understood before full implementation.

3 Approach to general issues

3.1 General approach

The issues raised in the consideration of the rule change requests are many and varied. At a general level, they relate to:

- a lack of flexibility and ability to adapt to changing external environments and different circumstances of NSPs;
- a limited ability to review or scrutinise, on the part of the regulator, the efficiency of capital expenditure before it becomes part of the regulatory asset base;
- a lack of opportunity for meaningful consumer engagement in the determination process; and
- ambiguity and a lack of clarity in some areas of the NER which has been impacting on the regulator's ability to scrutinise, review and, if necessary, revise capex and opex forecasts.

Taking these problems into account, the Commission's general approach in the context of the rule change requests can be described as follows:

- providing the regulator with the discretion to make decisions appropriate to the circumstances of each NSP in a changing environment. However, certain elements should be prescribed in the rules, such as the minimum requirements of the overall regulatory process to be followed;
- improving transparency and accountability in discretionary decision-making by requiring the regulator to address relevant factors and considerations;
- raising the level of decision-making to encourage a focus on the overall outcome - this is particularly evident in the area of capex incentives and the rate of return;
- requiring transparency and accountability on the part of NSPs by requiring them to provide more explanations for their proposals and decisions to consumers and to report to the regulator on the reasons for taking or not taking certain actions;
- encouraging more timely and meaningful consumer engagement;
- facilitating more productive and earlier engagement between the NSPs and the regulator;
- removing any identified ambiguities or lack of clarification or precision in the NER and NGR; and
- harmonising the approach in Chapters 6 and 6A of the NER, unless there are substantive reasons for a different approach.

Where the solutions involve providing increased discretion to the regulator, generally additional provisions will be included to require the regulator to take into account certain factors and considerations. These additional requirements will be included for a number of reasons, including:

- they are reflective of good regulatory practice as they improve transparency and accountability;

- they are consistent with the broader governance framework established by the NEL and the NGL which contemplate distinct roles for the rule maker and regulator; and
- together with the discretionary elements they reflect the appropriate balance for the current electricity regulatory environment (in place since 2006), bearing in mind that there has been only one full application by the AER of the current NER to each NSP. Chapters 6 and 6A can be regarded as a prescriptive and detailed articulation of the approach to incentive based regulation for electricity. The changes contemplated by this final position paper involve a departure from that approach only in so far as is warranted by recent developments and the current circumstances.

That is not to say, however, that the approach taken here could not evolve over time, as confidence in the application of the rules increases. As stated previously, including in the directions paper, these matters need to be considered on a case by case basis.

Amendments will be made to the rules where it has been demonstrated that a clear problem exists. Where evidence of a problem has not been provided or is not conclusive then the Commission has not made any changes. A good example here is the area of capex and opex allowances. In this area, the evidence provided of the problem was not conclusive and, on that basis, the Commission's changes are limited to addressing ambiguities and a lack of clarity.

3.2 Drivers for effective network regulation

The Commission is of the view that the package of amendments to be made to the NER and NGR in this final position paper provide the regulator with additional tools to carry out its functions. The effectiveness of the NER and the NGR in terms of the overall price and service outcomes experienced by consumers are dependent on two drivers:

- the effective application of the rules by the regulator; and
- the effective corporate governance of the NSPs providing services which are subject to economic regulation.

The efficiency with which network services are provided depends on the way in which the drivers work together. Only when these aspects are operating as intended will the best outcomes for consumers be achieved.

Regarding the first driver, the interpretation and application of the rules by the regulator is crucial. This final position paper provides examples and illustrations of how the final position rules could be interpreted and applied to address problems that exist currently, but also how their application could adapt when the circumstances change.

In their submissions on the draft rule determination, NSPs have proposed greater prescription in the rules. This appears to be driven by a lack of certainty about how the AER would apply increased discretion. The Commission's view is that rules that are made should assume a regulator that follows good administrative decision-making practice with adequate resources, and strives to make the best possible decisions.

In its submission in response to the draft rule determination, the AER states that the Commission's draft rule represents a significant improvement on the existing NER and address the major issues highlighted in the AER's rule change request. The AER also referred to some further amendments that would, in its view, improve the operation of the draft rules. Some of these amendments concerned the implementation of the draft rules. The AER suggested some amendments that, in its view, would better achieve the outcomes intended by the Commission.

As for all submissions received, the Commission has carefully considered the AER's comments made in response to the draft rule determination. Particular attention has been given to the AER's comments on the implementation of the rules given its role as regulator and the body primarily responsible for application of the rules. The Commission has carefully drafted the rules to reflect its overall position. In this context, the Commission has also consulted with the AER regularly on matters of drafting to be as certain as possible that the rules are correct, clear, and able to be applied by the AER, consistent with the Commission’s position.

In respect of the second driver, management and shareholders of service providers also play a critical role in the efficient provision of network services. They do this through a variety of means, such as approving proposals to be submitted to the regulator, given the significance of AER decisions for these businesses. They also create incentives within the business to encourage efficient outcomes. Without a shareholder seeking a commercial return for its investment the management of a service provider will not in practice face the strength of the incentive that would otherwise occur. This is because a shareholder seeking a below commercial rate of return provides the management with an ability to tolerate inefficiencies.

3.3 Merits review

While the Commission has been considering these rule change requests the Standing Council on Energy and Resources (SCER) decided to bring forward the review of the Limited Merits Review (LMR) regime in the NEL and the NGL. In April 2012 a panel was appointed to undertake the review. On 9 October 2012 the panel published its final stage two report.

The LMR Panel has observed that a narrower, and more formalistic approach to merits review has developed than what was originally intended. In its view this approach has been relatively detached from both the focus on the overall objectives set out in the NEL and NGL and also encouraging outcomes that are in the long term interests of consumers. The LMR Panel has proposed in its final stage two report that the NER and the NGR could be amended to clarify that decisions under those rules should be more holistic and broader, focussing on overall outcomes rather than component elements.

It is noted that, as a group of experts engaged by the SCER, the LMR Panel can only make recommendations, and it is up to the SCER to determine whether it will implement these recommendations, and if so how. It is worth noting, though, that the recommendations in the final stage two report that seek to encourage a greater focus on objectives and overall outcomes are consistent with this final position paper. Where possible, the final position rule seeks to allow and encourage the regulator to approach decision making more holistically. The main examples of this are requiring the regulator to focus on meeting overall objectives in relation to capex incentives and the rate of return that are linked to the NEO or NGO and the RPP. In line with this overall approach, the Commission is supportive of the review body being constituted, empowered, staffed and resourced in such a way as to be able to take the same holistic approach to the review of decision-making.

The Commission supports the need for accountability of the regulator through some form of merits review. Outcomes for consumers are likely to be improved if the proposed changes in the LMR Panel report to encourage a greater focus on objectives and overall outcomes by the review body are implemented. This final position paper and the final position rule, however, proceed on the basis of the merits review arrangements existing at this time. To the extent that the merits review arrangements change, there may need to be further rule changes as a result. These could include rule changes that arise directly out of such changes, some of which have been suggested by the LMR Panel.[13] They may also include consequential rule changes to align the rules with the changes to the NEL and NGL regarding issues such as the definition of a reviewable decision.

3.4 Role of consumers

In its rule changes request on electricity, the AER identified what it claimed were specific deficiencies in the way the regulatory process operates. Among other things, it stated that these deficiencies are denying some stakeholders the ability to have input into the regulatory process. On the basis of this and other claims in the rule change requests, the Commission has addressed the regulatory process in a holistic way to best deal with such deficiencies. This is discussed further in chapter 8.

The final position rules do not attempt to address perceived problems of engagement of consumers generally. For a start, this would go beyond the scope of the problems raised in the rule change requests and would therefore be beyond the Commission's rule-making powers. More conceptually though, this issue is fundamentally about how NSPs and the AER interact with consumers. While the final position rules in some areas, such as the expenditure forecasting assessment guidelines, require engagement to occur in a certain way, the rules should provide for the outcomes of engagement, not the engagement itself. Forcing parties to interact is unlikely to be successful in most cases. What is needed is a cultural shift towards greater engagement, and this can only come from the parties themselves. What the final position rules provide for in terms of engagement should be seen as a minimum. However, importantly the final position rules provide the AER with the ability to have regard to the nature of consumer engagement undertaken by service providers when evaluating their regulatory proposals.

On the basis that dealing with consumer engagement generally is outside this rule change process, SCER may wish to consider the issue of consumer engagement for processes under the NER or NGR.

13 LMR Panel, Review of the Limited Merits Review Regime, Stage Two Report, Report for the SCER, 30 September 2012, pp. 57-58.

3.5 The relationship between objectives and factors

The final position rules in a number of places are based on a structure which contains objectives and factors. For example, this structure can be found in both the rate of return provisions and the capex incentive provisions. There are other areas where, although there is no overall objective, there are factors for the regulator to consider. While the relationship between the objectives and factors is clearly expressed in the rules, its significance to the overall outcomes is such that it is further described here. In general the final position rules give the regulator greater discretion than it has currently. The objectives and factors show the regulator what it must bear in mind when it exercises that discretion.

The role of the objective is to indicate what the regulator should be *seeking* to achieve in the exercise of its discretion. Some stakeholders appear to have understood the objectives as imposing on the regulator a requirement and that failure to comply with this would mean the regulator is in breach of the rules. This is not the case. Although the language of an obligation is used in some objectives, it is not necessarily expected that the substance of the objective will always be fully achieved, but rather the regulator should be striving to achieve the objective as fully as possible. Where it is used in rate of return and capex incentives, the objective has primacy over other matters which the regulator is directed to consider.

These other matters include factors which the regulator is directed to consider. The rules use language such as "have regard to" and "take into account" to direct the regulator to consider certain factors. Throughout this rule change process there has been discussion over the respective meanings of these phrases. The Commission's approach is that these phrases mean the same thing and nothing is implied by the use of one rather than the other. The Johnson Winter & Slattery advice attached to the Australian Pipeline Industry Association (APIA) submission[14] includes a useful guide to how the phrases should be interpreted. The regulator must actively turn its mind to the factors listed, but it is up to the regulator to determine how the factors should influence its decision. It may, indeed, consider all of them and decide none should influence its decision. It is not intended that the regulator's decision is solely dependent on how it applies any or all of those factors. The intention is that where the rules require the regulator to consider certain factors in conjunction with an overall objective, it should explain its decision including how it has had regard to those factors in making a decision that meets the objective.

The objective, where one exists, should indicate to the regulator how the factors should influence its decision. The regulator should not assume that it may consider the factors (or other relevant provisions) and that this will of itself mean that the objective has been achieved. The overriding consideration for the regulator is the objective.

3.6 Approach to the following chapters

The directions paper and draft rule determination included summaries of responses to consultation in this rule change process. Unless indicated, in this final position paper,

14 APIA, Draft Rule Determination submission, 4 October 2012, p. 11.

where submissions are discussed, the discussion builds on the previous summary and focuses on new points made by stakeholders.

The draft rules specified the timing of the first guidelines required to be produced by the regulator under the draft rules. On the basis that this is not an ongoing provision of the rules, the timing of the first guidelines are now dealt with as part of the transitional arrangements, which will be published with the final rule determination by 29 November 2012.

4 Rate of return framework

Summary

- There is a strong case for a common framework under the NER and NGR for determining the rate of return.
- A new common rate of return framework will be implemented that requires the regulator to determine a rate of return (the allowed rate of return) that meets an overall objective focussed on the efficient financing costs a benchmark efficient service provider. The allowed rate of return will be estimated on a determination by determination basis to allow the regulator to better respond to changing financial market conditions.
- The new framework requires the regulator to develop and review rate of return guidelines that set out the approach it intends to take to determining the allowed rate of return. This will supplement the considerations at each regulatory determination/access arrangement. The guidelines must be reviewed at least every three years.
- The framework is intended to allow the regulator and the appeal body to focus on whether the overall estimate of the rate of return meets the overall objective for the allowed rate of return, which is closely linked to the NEO, the NGO and the RPP. While the regulator may choose to determine the rate of return by estimating other values to contribute to the allowed rate of return, the Commission considers that assurance that the overall objective is met can only be gained by considering whether the overall rate of return arrived at meets the stated objective.
- Estimating the rate of return ultimately requires a regulator to exercise judgement about the analytical techniques and evidence to use to make an estimate that is commensurate with efficient financing costs. The new framework does not prescribe methodologies or lock-in specific benchmark characteristics other than providing high-level principles that should be taken into account when estimating various components, such as return on equity and debt. While the judgement as to the best approach is left to the regulator, the preferred methods must be developed to meet the overall allowed rate of objective.

Difference between draft rule and final position rule

- The final position rule closely reflects the draft rule. To the extent submissions have raised concerns about the level of prescription and details in the draft rule, the Commission has considered them in this final position. The final position rule strikes an appropriate balance between flexibility and certainty for all stakeholders.
- The final position rule includes some minor drafting modifications from the draft rule to further reinforce the primacy of the overall objective when estimating the rate of return. The rules have also been re-ordered to better reflect the factors that the regulator must have regard to in estimating the

return on equity and return on debt components in achieving the allowed rate of return objective.

4.1 Introduction

The return on capital often represents the largest component of the revenue/pricing determinations of service providers. Therefore, the rules on how the rate of return is determined are a key element of the network charges that consumers pay. Under the building block approach to regulating revenues/prices, the return on capital is determined by applying a rate of return to the RAB (electricity) or projected capital base (gas) to determine the return on capital allowance to be included in the revenue requirement in each year of a service provider's regulatory determination or access arrangement.[15]

The current frameworks for estimating the rate of return for electricity transmission, electricity distribution and gas service providers differ in a number of respects. Differences include the extent of discretion available to the regulator and whether the estimate is made at each determination or in a periodic review. The current frameworks are in Chapter 6A of the NER for electricity transmission, Chapter 6 of the NER for electricity distribution, and rule 87 of the NGR for gas service providers.

A summary of the current frameworks, including the policy rationale for the frameworks when they were put in place, was provided in the AEMC's directions paper.[16] The directions paper also explained the AER's rule change request for the rate of return frameworks for electricity and gas transmission and distribution.[17]

Further analysis was provided in the draft rule determination, which also set out the draft rule provisions proposed to give effect to the Commission's conclusions on the AER's rule change request.[18]

This chapter does not include a discussion on issues relating to the estimation of return on debt although it is an integral part of determining the overall rate of return. Such a discussion is included in chapter 5 of this final position paper.

The remainder of this chapter is structured as follows:

- section 4.2 summarises the Commission's position in the draft rule determination;
- section 4.3 summarises the submissions received in response to the Commission's draft rule determination;
- section 4.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- section 4.5 provides guidance on the final position rule.

---

15 See NER clauses 6A.6.2(a) and 6.5.2(a). See also NGR rule 76(a).

16 See AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, pp. 67-71.

17 Id., pp. 71-73.

18 See AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, pp. 32-61.

4.2 Directions paper and draft rule determination

4.2.1 Assessment of existing frameworks

Chapter 6A of the NER

The Commission retained its initial view from the directions paper that the rate of return framework under Chapter 6A of the NER is insufficiently flexible to be the best framework for achieving the NEO and RPP in the future.[19] This assessment was based on the view that fixing WACC parameters for long periods produces results that may not reflect current market conditions. Further, it limits the set of information available for estimating parameter values.

The global financial crisis and its continuing impact through the European sovereign debt crisis have highlighted the inherent dangers in an overly rigid approach to estimating a rate of return in unstable market conditions. This is because the framework in Chapter 6A does not allow for a WACC review outside of the periodic schedule. In addition, the Chapter 6A framework does not permit decisions made at a WACC review to be subject to merits review.

The Commission also expressed concern that the provisions create the potential for the regulator and/ or appeal body to interpret that the best way to estimate the allowed rate of return is by using a relatively formulaic approach. This may result in it not considering the relevance of a broad range of evidence, and may lead to an undue focus on individual parameter values rather than the overall rate of return estimate.

Chapter 6 of the NER

The Commission's conclusion on the rate of return framework under Chapter 6 of the NER was that, while it was more flexible than the Chapter 6A framework, it had shortcomings that meant it was not the best available framework for achieving the NEO, the NGO and the RPP in future.[20]

The Commission made three specific points on the lack of suitability of the current Chapter 6 rate of return framework as a foundation for a common rate of return framework:

- the rules should allow the inter-relationships between parameters to be appropriately considered. This will encourage the regulator to focus on whether its overall estimate of the rate of return is appropriate;
- the rules and their interpretation have led to an undue focus on individual values rather than the overall estimate of the rate of return; and
- the persuasive evidence test is problematic. Although regulatory certainty is desirable, it should not be attained at the expense of limiting the regulator's ability to make the highest-quality rate of return estimate at any particular time.

---

19 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, pp. 39-40.AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, pp. 78-80.

20 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, pp. 40-41.

Part 9 of the NGR

In contrast to the electricity frameworks, the Commission concluded that the NGR rate of return framework provides considerable discretion and flexibility, and is intended to be focussed on obtaining a good overall estimate of a rate of return.[21] The Commission considered that the approach of the rate of return framework in the NGR is better aligned with one that could best achieve the NEO, the NGO and the RPP. This is because the NGR specifies an overall objective for the rate of return that directly aligns the estimation process towards achieving the NGO and the RPP.

However, it was noted that the considerable flexibility of this framework did not appear to have been taken advantage of in practice. This may be due to approaches from the more prescriptive electricity regimes influencing the gas regime. Moreover, recent decisions of the Tribunal have interpreted the NGR rate of return framework to apply in such a way as to reduce the range of information that can be used in estimating the rate of return.[22] Such application could lead to the adoption of relatively formulaic approaches to determining the rate of return rather than focussing on the overall estimate.

The Commission observed that under the current NGR rate of return framework, stakeholders would have to participate in every access arrangement decision to influence the regulator's methodology, which may involve relatively high costs.[23] For some stakeholders, such as consumer representative groups, this could impose such significant costs that it acts as a barrier to participation. On the other hand, developments in the regulator's methodology through gradual learning in each access arrangement process can be good regulatory practice.

Overall, the Commission considered that the policy objective of the rate of return framework in the NGR was most consistent with the NEO, the NGO and the RPP. However, recent interpretation of specific rules by the Tribunal meant that the Commission could not be confident that, without amendment, the current NGR framework would be likely to deliver outcomes that best meet the NEO, the NGO and the RPP.

---

21 Id., pp. 41-43

22 *Application by WA Gas Networks Pty Ltd (No 3)* [2012] ACompT 12 and *Application by DBNGP (WA) Transmission Pty Ltd (No 3)* [2012] ACompT 14. The Tribunal's decisions in both cases concerned a number of issues with direct relevance to the rate of return provisions in the NGR. Among those issues, the Tribunal considered what it termed the "rule 87 construction issue", which pertained to the proper interpretation of the operation NGR rules 87(1) and 87(2).

23 In the draft rule determination, it was noted the regulator may decide to have a separate consultation, as the Economic Regulation Authority (ERA) did when it developed its bond yield approach for estimating the return on debt that it proposed in recent decisions. See ERA, *Measuring the Debt Risk Premium – A bond yield approach*, Discussion Paper, 1 December 2010; ERA, *Final decision on WA Gas Networks Pty Ltd proposed revised access arrangement for the Mid-West and South-West Gas Distribution Systems,* 28 February 2011; and ERA, *Final decision on proposed revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline*, 31 October 2011 (as amended on 22 December 2011). The Commission notes that both the access arrangement decisions have amended in accordance with the Tribunal's recent decisions.

Conclusion

The Commission took the view that none of the existing rate of return frameworks are capable of best fulfilling the requirements of the NEO, the NGO and the RPP. The Commission considered that a new rate of return framework is therefore needed.[24]

Moreover, the new framework should be common across the NER and the NGR. The Commission noted that it has not seen any convincing evidence to support the view that there are features of the electricity and gas sectors that would justify different frameworks for estimating the rate of return for each sector.

The Commission recognised that each sector currently has a different framework, and there can be benefits from stability of frameworks over time. However, given the concerns with each of the existing frameworks, the benefits of a common one appeared to significantly outweigh any potential benefits from preserving the stability of any of the existing frameworks.

In the directions paper, the Commission proposed that a good rate of return framework would be one that:

- is based around estimating a rate of return for a benchmark efficient service provider;
- allows methodologies for parameters to be driven by principles and to reflect current best practice;
- allows flexibility to deal with changing market conditions and the availability of new evidence;
- recognises the inter-relationships between parameter values; and
- creates a framework of accountability for both the regulator and the service provider in determining an appropriate rate of return.[25]

There was broad agreement amongst stakeholders about the appropriateness of these five attributes.[26]

In the draft rule determination, the Commission decided that two further key attributes should be considered, which were:

- certainty for service providers and their investors as to how the regulator will react to changes in market circumstances and make decisions on an appropriate rate of return; and
- a rate of return framework that allows for more effective consumer participation.

---

24 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 43.

25 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, pp. 91-92.

26 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 44.

4.2.2 Features of a new common rate of return framework

Estimating a rate of return for benchmark efficient service provider

The draft rule determination stated that the primary objective of the allowed rate of return is to provide service providers with a return on capital that reflects efficient financing costs. A rate of return that reflects efficient financing costs will allow a service provider to attract the necessary investment capital to maintain a reliable energy supply while minimising the cost to consumers. The Commission also stated that it is important for recovery of financing costs to be based on benchmark efficient finance costs. This is to provide incentives for firms to adopt efficient financing arrangements and to protect consumers from the effects of inefficient ones.

It was also highlighted that there is a need to bring the focus of the rate of return estimate in the rules back to the NEO, the NGO and the RPP. The Commission's proposed rate of return framework therefore had an overall objective for the allowed rate of return. In order to meet the NEO and the NGO, this objective reflected the need for the rate of return to "correspond to" the efficient financing costs of a benchmark efficient entity, this entity being one with similar circumstances and degree of risk to the service provider.

Methodologies driven by principles and reflecting current best practice

Achieving the NEO, the NGO, and the RPP requires the best possible estimate of the benchmark efficient financing costs. The Commission stated that this can only be achieved when the estimation process is of the highest possible quality. The draft rule determination stated that this meant that a range of estimation methods, financial models, market data and other evidence must be considered. At the same time, the regulator requires discretion to give appropriate weight to all the evidence and analytical techniques considered.

The Commission considered that the approach in the NGR rate of return framework provides a sound basis on which to build a new rate of return framework. The less prescriptive nature provides sufficient flexibility to consider alternative methodologies. It can also allow the regulator to consider new evidence as it emerges and adjust or adapt its methodologies if justified.

Flexibility to deal with changing market conditions and new evidence

It was determined that a robust and effective rate of return framework must be capable of responding to changes in market conditions. If the allowed rate of return is not determined with regard to the prevailing market conditions, it will either be above or below the return that is required by capital market investors at the time of the determination. The Commission was of the view that neither of these outcomes is efficient nor in the long term interest of energy consumers.

The Commission concluded that the NGR rate of return framework potentially provides the flexibility needed to take account of changing market conditions and the availability of new evidence. The NGR rate of return framework achieves this by allowing the rate of return to be determined during each access arrangement decision, unconstrained by outcomes of any review. However, it was also of the view that this approach did raise concerns about the ability of all stakeholders, including consumers and their representative groups, to participate in rate of return determinations on an ongoing basis.

As a result, the Commission's proposed rate of return framework required the rate of return to be determined at the time of each regulatory determination under the NER and each access arrangement decision under the NGR. The Commission considered that a requirement for guidelines (discussed below) on rate of return methodologies to be developed by a regulator would provide the ideal mechanism to achieve both effective consumer engagement and regulatory predictability.

Inter-relationships between parameter values

In its draft rule determination, the Commission stated that, for a rate of return estimate to be reliable, it must properly reflect any interactions between the parameters in the estimation process. In some financial models, two or more parameters are either mathematically linked (ie the relationship between them can be expressed in the form of a mathematical formula) or they may be linked in other ways due to the underlying assumptions made in estimating various parameters. The Commission noted that proper implementation of a model would require that any relationship between parameters be recognised when estimating those parameters as part of deriving the overall rate of return estimate.

Stakeholders suggested that the existing Chapter 6 rate of return framework allowed for such inter-relationships to be taken into account. However, the Commission saw very limited evidence of how this occurs in practice.

The Commission's proposed new rate of return framework explicitly recognised such parameter inter-relationships by requiring the regulator and the service provider to have regard to them.

Accountability for both the regulator and the service providers

The decision was taken that, in developing a new rate of return framework, accountability of the regulator and the service provider is important. The Commission's proposed rate of return framework in the draft rule determination achieved this accountability in a number of ways:

- the return on equity estimate was proposed to be derived from a range of different estimation methods, financial models, market data and other evidence, ensuring that it is informed by and tested against the range of relevant evidence;
- the framework required the regulator and the service providers to be continually measuring their choice and application of estimation methods, financial models, market data and other relevant evidence against the overall objective of a rate of return that corresponded to the efficient financing costs of a benchmark efficient service provider; and
- the regulator would be required to develop rate of return guidelines as part of a transparent consultative process and periodically review those guidelines.

In addition, the fact that the proposed rate of return framework would be part of a reviewable decision meant that service providers are able to seek merits reviews of the regulator's decision.

Regulatory certainty

During consultation, regulatory certainty was highlighted by many service providers and investor groups to be an important aspect of the rate of return framework. The Commission recognised that there is some tension between having flexibility and certainty in the framework. On the one hand, investors require certainty in the regulatory regime on how the rate of return will be determined in the future. On the other hand, investors also require certainty that where market conditions change, the regulatory regime will provide enough flexibility to the regulator to make the necessary adjustments to determinate an appropriate rate of return.

In its draft rule determination, the Commission stated that the NGR rate of return framework represented a stronger attempt at ensuring that the determination of the rate of return meets the NEO, the NGO and the RPP. This was because it placed primary importance on determining an overall rate of return that promotes efficient use and investment, ensuring that a desire for certainty and predictability does not inhibit this being achieved.

The Commission also gave consideration to a suggestion from NSPs that if a rate of return framework based on the NGR determination by determination approach were to be adopted, then there should be an "inertia principle" included in the rules. This would require the parameter values of previous regulatory determinations to be binding until variation is sought that passes some form of persuasive evidence test. It was suggested that some parameters by their nature are subject to significant ongoing discussion and that two experts could look at the same material and come up with multiple answers. It was suggested that use of this type of "evidence" would reduce certainty, stability and transparency in the regulatory framework.

In its draft rule determination, the Commission took the view that inclusion of an inertia principle would undermine the strength of its proposed rate of return framework. The Commission further noted that its proposed non-binding rate of return guidelines would safeguard the framework against the problems of an overly-rigid prescriptive approach that cannot accommodate changes in market conditions. Instead, sufficient flexibility would be preserved by having the allowed rate of return always reflecting the current benchmark efficient financing costs.

The non-binding nature of the guidelines would not work against regulatory predictability (or the inertia principle). Rather, it would promote it since the regulator would, in practice, be expected to follow the guidelines unless there had been some genuine change in the evidence. The regulator would also need to explain why it was deviating from the guidelines. Similarly, service providers would need to explain in their regulatory proposals why they are proposing a different approach to the regulator’s guidelines if they wished to advocate a different approach. This would not limit a service provider’s ability to submit that there was a change in evidence or circumstances that required a variation. Additionally, each regulatory determination would remain subject to merits review as a reviewable decision, allowing the appeal body to maintain appropriate oversight over the regulator's decision.

More effective consumer participation

It was noted in the draft rule determination that one of the key drawbacks of the NGR rate of return framework was that it may not allow for more effective consumer participation. That is because it operates on a determination by determination basis. This is particularly so where there are a lot of relatively small consumers and their representative groups have resource constraints which limit their ability to effectively engage on that basis. Accordingly, the Commission would prefer to have a rate of return framework that provides both periodic consultation and a mechanism for allowing consumer consultation to be given proper effect.

The Commission considered that a useful way to achieve effective consumer engagement would be through the use of guidelines, which also helps to address concerns about regulatory certainty. The rate of return guidelines can play the role of outlining the methodologies that the regulator proposes to use in determining the allowed rate of return at the time of a regulatory determination. The guidelines could be developed and thereafter reviewed periodically, using an extensive consultation process. This would allow consumers to effectively engage in the creation and review of such guidelines.

4.2.3 Nominal post-tax rate of return

In proposing a new common rate of return framework, the Commission had to consider whether the mandated nominal post-tax approach in the NER should be extended to the NGR framework. In the draft rule determination, the Commission considered the rationale the AEMC provided in prescribing a nominal post-tax approach in Chapter 6A, in its 2006 Chapter 6A determination. The Commission noted that the nominal post-tax approach was prescribed in the NER because:

- the post-tax approach addressed concerns regarding overcompensation for tax in the early years of an asset's life, due to accelerated depreciation provisions for tax purposes which continue to apply to some TNSP assets; and
- convergence in modelling approaches across different energy businesses would improve the ability to compare returns across different regimes, whereas allowing differences in the frameworks applying to TNSPs and DNSPs would not aid in such a convergence.[27]

The draft rule determination noted that the pre-tax and post-tax approaches produce equivalent outcomes provided that the effective company tax rate is properly calculated under the pre-tax framework. Generally, where a pre-tax approach has been adopted, regulators have adopted either the statutory tax rate or a simple and conservatively high assumption for the effective tax rate.

The Commission also gave weight to comments from the AER and the Economic Regulation Authority (ERA). Both submitted that the use of the company tax rate and a conservatively high assumption of the effective tax rate can lead to systematic overcompensation for company tax. The AER also submitted that eliminating the

27 AEMC, *Draft national electricity amendment (Economic regulation of transmission services) rule 2006 - Transmission revenue: rule proposal report*, February 2006, pp. 63–64.

potential for overcompensation requires the precise calculation of an effective tax rate, which is administratively burdensome. Moreover, the calculation of an effective tax rate requires cash flows to be modelled in post-tax terms and then converted into pre-tax equivalents. That is, the regulator would perform a post-tax calculation in either case. As a result, the Commission took the view that a common rate of return framework across the NER and NGR should apply the nominal post-tax approach.

The nominal post-tax approach is already applied consistently under the NER. Prescribing a nominal post-tax approach in the NGR offers benefits such as:

- streamlining the access arrangement review process;
- providing certainty for gas service providers as to the basis on which the regulator will determine the allowed rate of return;
- allowing convergence in modelling approaches across the different sectors; and
- improving the ability to compare returns across the different sectors.

As observed by the AEMC in its Chapter 6A determination, allowing differences in the frameworks applying to different types of service providers would not aid in such a convergence.

4.2.4 Implications of the Tribunal decision in the ATCO Gas and DBP cases

In developing the new rate of return framework for the draft rule determination, the Commission also provided reasons for why it had not adopted the broad architecture of the NGR rate of return framework given it exhibited a number of the identified key features of a good rate of return framework. The Commission was not convinced that the existing NGR rate of return framework would best meet its proposed approach in light of the recent decisions of the Tribunal in the ATCO Gas and DBP merits reviews and their implications for how the Commission intends its framework to be interpreted.

In both the ATCO Gas and DBP cases, the Tribunal rejected the contention of the applicants that giving primary emphasis to rule 87(1) would reflect the NGO and the RPP.[28] Such a conclusion does not reflect the approach of the Commission to determining an appropriate rate of return. The Commission considers that the primary consideration should be whether or not the overall allowed rate of return reflects benchmark efficient financing costs. A focus on the overall estimate of the rate of return is the key objective of the new framework.

The Tribunal suggested in both of these cases that rule 87(1) lacks guidance as to how the objective is to be achieved. Further, it stated that in the interests of regulatory consistency, it is desirable that such guidance be provided, and that rule 87(2) serves that function in describing how the rate of return is to be achieved.[29]

The Tribunal also held that "implicit (or explicit) criticisms of modelling... must be minimised, if not negated, by the requirement that the approach and the model used

---

28 *Application by WA Gas Networks Pty Ltd (No 3)* [2012] ACompT 12; *Application by DBNGP (WA) Transmission Pty Ltd (No 3)* [2012] ACompT 14.

29 *Application by WA Gas Networks Pty Ltd (No 3)* [2012] ACompT 12, [61] – [63]; *Application by DBNGP (WA) Transmission Pty Ltd (No 3)* [2012] ACompT 14, [81]-[83].

must be well accepted by those who undertake and use such approaches and models for that purpose".[30] As a result "it is almost inherently contradictory then to say that the approach or the model is not likely to produce a reliable output - assuming that the inputs are appropriate – if that approach and that model are well accepted".[31]

The Commission considered that this conclusion presupposes the ability of a single model, by itself, to achieve all that is required by the objective. The Commission is of the view that any relevant evidence on estimation methods, including that from a range of financial models, should be considered to determine whether the overall rate of return objective is satisfied.

The Commission therefore emphasised that a focus on the overall estimate of the rate of return was a key objective of the new rate of return framework. The Commission considered that requiring the regulator to have regard to relevant information on estimation methods, financial models, market data and other evidence, and allowing the regulator more capacity to achieve the overall objective, combined with a strengthened emphasis on achieving this objective, is more likely to achieve the NEO and the NGO than the current approaches.

The Tribunal also highlighted its concerns regarding insufficient prescription:

> “The measure of prevailing conditions in the market for funds, and of the risks involved in providing reference services - without prescribing finally how that is done - would be fraught and vulnerable to an evolutionary and possibly idiosyncratic series of regulatory decisions. It would provide less certainty. It would expose the process of selection of rate of return on capital to the risk of prolonged debate about the relevant factor, their empirical measurement and their weightings.[32]”

The Commission stated that it was mindful of the potential consequences of removing prescription and allowing the regulator increased discretion. However, the Commission noted that the potential consequences must also be balanced against potential benefits. Regulatory discretion is an important feature of every regulatory regime and guidance that is too prescriptive runs the risk of unnecessarily limiting the achievement of the NEO and the NGO. The focus should be on the outcome of the process rather than on individual steps of the process itself. The Commission considered that no one method can be relied upon in isolation to estimate an allowed return on capital that best reflects benchmark efficient financing costs.

The Commission took the view that a mechanism for addressing, or at least mitigating, the Tribunal’s concerns regarding "idiosyncratic series of regulatory decisions", "less certainty" and "prolonged debate" was the use of guidelines on rate of return methodologies under the new framework.

---

30 *Application by WA Gas Networks Pty Ltd (No 3)* [2012] ACompT 12,at [63]; *Application by DBNGP (WA) Transmission Pty Ltd (No 3)* [2012] ACompT 14, [84].

31 Ibid.

32 *Application by WA Gas Networks Pty Ltd (No 3)* [2012] ACompT 12, [68]; *Application by DBNGP (WA) Transmission Pty Ltd (No 3)* [2012] ACompT 14, [89].

4.3 Submissions

4.3.1 Views on the level of prescription in the rules and level of detail required by the guidelines

Two closely-related issues that attracted significant comments in most submissions are the level of prescription in the draft rule and the level of detail required in the rate of return guidelines. Views expressed on these two issues are wide-ranging.

The AER suggests that the overall objective for the allowed rate of return is better achieved by removing from the draft rule the requirements for how the overall rate of return is determined.[33] It suggests that such requirements are better cast as criteria to which the regulator must have regard.

By contrast, the ERA takes the view that not specifying a rule like the existing rule 87(2) in the NGR would lead to a prolonged debate through the process of appeal to the Tribunal.[34]

The ENA submits that the AER should be required to provide sufficient details in the proposed rate of return guidelines to enable stakeholders to derive proxy estimates of the rate of return.[35] This call for greater detail being required in the guidelines has widespread support among submissions from electricity NSPs predominantly but not exclusively.[36]

Gas service providers are generally opposed to any detail being mandated in the proposed rate of return guidelines that could potentially lead to "locking-in" of parameter values. Gas service providers are nonetheless of the view that the draft rule should be further strengthened to require the regulator to use multiple methods, models and evidence in estimating the rate of return.[37]

That there is nothing in the draft rule that prevents the regulators from continuing their reliance on CAPM is a common concern.[38] Some submissions advocate that the regulator should be required to assign weights to the financial models that it intends to use and to explain its rationale for both these weights and the choice of models.[39]

33 AER, Draft Rule Determination submission, 5 October 2012, pp. 16-17.

34 ERA, Draft Rule Determination submission, 4 October 2012, pp. 5-6.

35 ENA, Draft Rule Determination submission, 4 October 2012, p. 2.

36 See, for example, SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 2-3; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 13-14; Jemena, Draft Rule Determination submission, 4 October 2012, pp. 23-26; UE and MG, Draft Rule Determination submission, 4 October 2012, pp. 10-11; QTC, Draft Rule Determination submission, 4 October 2012, pp. 5-6.

37 APIA, Draft Rule Determination submission, 4 October 2012, pp. 10-15; APA Group, Draft Rule Determination submission, 4 October 2012, p. 3; DBP, Draft Rule Determination submission, 9 October 2012, pp. 2-4; ATCO Gas, Draft Rule Determination submission, 4 October 2012, pp. 6-13

38 See, for example, The Financial Investor Group, Draft Determination submission, 4 October 2012, pp. 17-19; APIA, Draft Rule Determination submission, 4 October 2012, pp. 10-12; QTC, Draft Rule Determination submission, 4 October 2012, pp. 4-5.

39 See, for example, QTC, Draft Rule Determination submission, 4 October 2012, pp. 6-7; Ergon Energy, Draft Determination submission, 7 October 2012, p. 5.

In general, consumer representative groups are satisfied with additional flexibility being provided in the draft rule to the regulator.[40] However, the MEU is particularly concerned that the rule should define a benchmark efficient entity and the basis on which this is to be identified.[41] The EUAA approached the issue of discretion and prescription from a different perspective, submitting that, on the basis of its analysis of past performance of the regulator on the level of rate of return set, it is unlikely that greater discretion for the AER will significantly impact on the regulator's ability to (potentially) set lower rates of return.[42] This view is shared by other consumer representative groups who commented on the draft rule determination.[43]

4.3.2 Departure from the rate of return guidelines

Electricity NSPs and the ENA suggest that the removal of a persuasive evidence test from the NER rate of return frameworks skews the balance too far toward flexibility from transparent and evidence-based decisions.[44] The electricity service providers are concerned that the Commission's draft rule was increasing the AER's discretion at the same time as evidentiary thresholds were being removed.[45] These submissions called for stronger requirements on a party proposing departure from the rate of return guidelines to justify its reasons and evidence for doing so, based on sound theoretical arguments and verifiable evidence.[46]

By contrast, the APIA and other gas service providers are not particularly in favour of the draft rule requirement for the regulator and the service provider to explain departure from the guidelines as they are concerned that this would result in a tendency for regulators to adhere to guidelines, even in the face of evidence for departure at the time of an access arrangement decision.[47] Arguments were made that though the rate of return guidelines would not be mandatory in their application, they would clearly have presumptive force, leading to concerns that the rate of return guidelines could "inadvertently become a way of entrenching non-reviewable errors".[48]

---

40 Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 3.

41 MEU, Draft Rule Determination submission, 4 October 2012, pp. 11-12.

42 EUAA, Draft Rule Determination submission, 3 October 2012, pp. 6-7.

43 ATA, Draft Rule Determination submission, 4 October 2012, pp. 7-8; UnitingCare Australia, Draft Rule Determination submission, October 2012, pp. 7-8.

44 See, for example, ENA, Draft Rule Determination submission, 4 October 2012, pp. 12-13; Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 3; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 2; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 11-12.

45 See for example, SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 3.

46 See for example, ENA, Draft Rule Determination submission, 4 October 2012, pp. 12-13; Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 3; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 2; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 11-12.

47 See, for example, APIA, Draft Rule Determination submission, 4 October 2012, p. 14; ATCO Gas, Draft Rule Determination submission, 4 October 2012, pp. 10-13.

48 ATCO Gas, Draft Rule Determination submission, 4 October 2012, p. 12.

4.3.3 Development of the rate of return guidelines

Some stakeholders are concerned about the adequacy of the proposed consultation procedures for the periodic review of the rate of return guidelines. For example, some submissions suggested that thirty business days was insufficient time for responding to consultation papers or draft guidelines, and the consultation period should be increased to at least sixty business days.[49] APIA is of the view that, given the introductory nature and the broad range of matters to be considered, the proposed timetable for the first set of rate of return guidelines is too short.[50] Another concern raised by APIA is the absence of a consultation step before the regulator issues its draft guidelines.[51]

Some submissions called for the review period of the guidelines to be lengthened to a four year cycle.[52]

On a related issue, a question was raised as to which rate of return guidelines would apply to a regulatory determination, particularly given the frequency of guideline updates. For example, the submission from SA Power Networks (formerly ETSA Utilities), CitiPower and Powercor claimed that the draft rule was ambiguous as to which rate of return guidelines would apply to a service provider where the guidelines were issued between the draft and final determinations. These NSPs suggested that this issue could be resolved by amending the draft rule to mandate the application of the guidelines that are in force at the time the framework and approach paper is published.[53] Similarly, it was suggested that it is important that the first guidelines be finalised before any service provider is required to submit under it.[54]

4.3.4 Nominal post-tax basis requirement

Generally, submissions that commented on the draft rule proposal to mandate the rate of return calculations on a nominal post-tax basis were seeking clarification that the AEMC's intention is to preserve the "vanilla WACC" approach currently adopted by the AER.[55]

There were some submissions that did not support the Commission's draft rule proposal. ATCO Gas submits that there should not be a requirement in the rules to use a nominal post-tax approach, claiming that such a requirement would be inconsistent with the flexible approach intended by the Commission.[56] Contrary to the ERA's

49 See for example, ENA, Draft Rule Determination submission, 4 October 2012, p. 15; QTC, Draft Rule Determination submission, 4 October 2012, p. 8; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 4.

50 APIA, Draft Rule Determination submission, 4 October 2012, p. 12.

51 APIA, Draft Rule Determination submission, 4 October 2012, p. 13.

52 ENA, Draft Rule Determination submission, 4 October 2012, p. 15; Jemena, Draft Rule Determination submission, 4 October 2012, p. 25.

53 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 13.

54 APA Group, Draft Rule Determination submission, 4 October 2012, p. 4.

55 See for example, ENA, Draft Rule Determination submission, 4 October 2012, p. 10; SP AusNet, Draft Rule Determination submission, 4 October 2012. p. 2;

56 ATCO Gas, Draft Rule Determination submission, 4 October 2012, pp. 5-6.

previous submission to the rule change request, while it supported the specification of a post-tax rate of return under the NGR, it stated that there should be no requirement for the approach to be on a nominal basis.[57]

The AER did not express any disagreement with a nominal post-tax approach being made mandatory under the draft rule.[58]

4.3.5 Departure from NSP's proposal on rate of return

The ENA and some NSPs disagree with the Commission's proposal that the allowed rate of return decisions be removed from those decisions that the regulator must make on the basis of what the NSP proposes in its regulatory proposal. That is, they consider that the constraints that apply to the AER's decisions by virtue of clauses 6.12.3(f) under Chapter 6 and 6A.13.2(a) and 6A.14.3(b) under Chapter 6A should apply to the AER's rate of return decisions.[59]

The ENA argue that, while a carve out from clauses 6.12.3(f), 6A.13.2(a) and 6A.14.3(b) might be appropriate for forecast opex and capex to discourage strategic behaviour, it is not necessary for rate of return since it is not affected by information asymmetry.[60] It was submitted that retaining the existing position would improve regulatory certainty and predictability given the increased uncertainty stemming from the increase in flexibility afforded to the regulator under the draft rule.[61]

4.3.6 Other Issues

Though generally most submissions agree with the overall approach taken by the Commission in the draft rule determination and the draft rule, there were numerous submissions that either suggested the drafting could be improved to better give effect to the Commission's intention or that certain concepts required clarification.

A common suggestion is that the words "commensurate with" should be included as part of the words of the overall allowed rate of return objective. For example, the ENA states that unless there is a deliberate reason for not doing so, the allowed rate of return objective should ideally use terminology consistent with the NEL and the RPP, and not doing so could give rise to unintended consequences.[62]

A related but distinct proposal calls for the reinstatement of "commensurate with the prevailing conditions in the markets for funds" as part of the proposed overarching allowed rate of return objective.[63] It was also recognised though that a potential

57 ERA, Draft Rule Determination submission, 4 October 2012, pp. 2-5.

58 AER, Draft Rule Determination submission, 5 October 2012, p. 17.

59 See, for example, ENA, Draft Rule Determination submission, 4 October 2012, pp. 19-21; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 12-13.

60 ENA, Draft Rule Determination submission, 4 October 2012, p. 20.

61 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 13.

62 ENA, Draft Rule Determination submission, 4 October 2012, p. 20.

63 APIA, Draft Rule Determination submission, 4 October 2012, pp. 8-9; DBP, Draft Rule Determination submission, 9 October 2012, p. 3.

adoption of the trailing average approach to debt for some NSPs may have necessitated the excision of this phrase.[64]

In a similar vein, there is concern from gas service providers that the requirement for the return on equity estimation to "take into account" the prevailing conditions in the market for equity funds is not as strong as under the existing rule 87 of the NGR and argued that this needed to be strengthened.[65]

Regarding this same draft rule provision, submissions from the ENA and others suggest that the Commission should clarify that it is not seeking to prevent the consideration of historical or realised returns.[66]

The QTC submits that it is important to clarify that references to "best estimates" relate to those which best promote the NEO, NGO and RPP, rather than the most accurate estimate from a purely statistical perspective.[67]

Some stakeholders also query what the intention was regarding the proposed requirement in the draft rule for consistent application of estimates of financial parameters.[68]

The submission from APIA seeks further clarity as to what was intended by "efficient financing costs". APIA suggests that efficient financing costs does not have a readily recognised meaning in the context of economic regulation. Similarly, APIA suggests that "benchmark efficient entity" requires clarification.[69] The MEU is strongly in favour of "efficiency" being defined in the NER and NGR as well as what it considered to be a "benchmark" entity and the basis on which this is to be defined.[70] ATCO Gas expressed the view that benchmarking should reflect the realities of the regulated entity.[71] A different approach is proposed by the Financial Investor Group (FIG), which recommends that "efficient entity" should be defined with reference to a benchmark network business in a competitive market.[72]

4.4 Analysis

This section responds to issues raised in submissions to the draft rule determination and sets out the Commission's reasoning for its final position.

64 APIA, Draft Rule Determination submission, 4 October 2012, pp. 9-10; APA Group, Draft Rule Determination submission, 4 October 2012, p. 3.

65 See, for example, APIA, Draft Rule Determination submission, 4 October 2012, p. 9.

66 ENA, Draft Rule Determination submission, 4 October 2012, p. 15; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 3.

67 QTC, Draft Rule Determination submission, 4 October 2012, p. 5.

68 See, for example, ENA, Draft Rule Determination submission, 4 October 2012, p. 10; ATCO Gas, Draft Rule Determination submission, 4 October 2012, pp. 7-8; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 11.

69 APIA, Draft Rule Determination submission, 4 October 2012, p. 7.

70 MEU, Draft Rule Determination submission, 4 October 2012, pp. 6-12.

71 ATCO Gas, Draft Rule Determination submission, 4 October 2012, pp. 3-5.

72 The Financial Investor Group, Draft Determination submission, 4 October 2012, pp. 17-19.

4.4.1 Level of prescription in the rules

There is broad support from stakeholders on the Commission's draft rule to introduce a flexible rate of return framework that is common across the electricity and gas transmission and distribution sectors. However, there is considerable concern about how the regulator may exercise the necessary discretion that comes with having a flexible framework that can evolve over time.

Therefore, a fundamental issue raised in submissions is how much prescription the NER and NGR and the rate of return guidelines should have to best allow the realisation of the Commission's policy intent. This section provides the Commission's response to some of the key aspects of this issue.

Flexibility and Certainty

The Commission explicitly recognised in the draft rule determination the potential tension between flexibility and certainty in the rate of return framework.[73] Resolving this tension must always be guided by what is most likely to achieve the NEO, NGO and the RPP.

The Commission understands from submissions that much of the concern with the additional flexibility provided in the new framework reflects a lack of understanding from stakeholders about how the regulator will apply the new rules. Stakeholders also appear to be concerned about the direction on the various estimation techniques the regulator may take under the new framework. For instance, the current regulatory approach of using only the CAPM for estimating the return on equity was cited as an example that could be used to undermine the outcomes expected in the new framework. This would be where the regulator may choose to continue to justify using the CAPM without considering other models. To this end, varying suggestions were made to explicitly require the regulator to consider and provide weights to different financial models to improve the certainty of other models having some utility.

The Commission considers that the NER and the NGR in this context are about providing the regulator with the ability and necessary guidance to regulate the revenues and prices of monopoly networks service providers. In discharging their economic regulatory functions the AER and the ERA are required to consider their decisions in terms of achieving the NEO, NGO and the RPP. The regulator should be expected to follow good administrative decision-making practice. In this context, such practice requires a full and considered explanation for decisions and adherence to due process, rigour and objectivity required under administrative law principles. That the regulator would strive for the highest quality estimates to best achieve the NEO, NGO and the RPP can be necessarily expected. If a service provider considers that the regulator has fallen short in this regard, then it can consider appealing the regulator's decision. The Commission is of the view that the NER and NGR cannot, and should not, be an exercise in rigidly specifying actions for the regulator that are already incumbent upon it.

73 See, for example, AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 51.

The Commission's focus has been to appropriately balance flexibility and certainty in the NER and the NGR. While certainty for investors and service providers is of considerable importance, it is not the only consideration. The certainty of which parameters should be estimated, how they should be estimated and once estimated, locking them in for substantial period of time is a feature of the existing NER frameworks. However, this approach to achieving certainty has considerable drawbacks.

The cost of this certainty through the prescriptive rigidity in the rules not only affects service providers when market conditions adversely change, but also consumer interests. This is not to suggest that providing certainty should not be an objective and cannot be achieved through other means. Indeed, the Commission has attempted to provide some level of certainty to balance the flexibility objective through requiring the regulator to develop and periodically review rate of return guidelines on the methodologies it intends to use to estimate the rate of return over a three year period. That is, certainty on the regulator's approach is provided through another mechanism that still preserves the level of flexibility that should naturally exist in rate of return estimations.

Rules

The Commission has taken the view that guidance in the NER and the NGR is beneficial unless it limits the flexibility of the regulator to make decisions more likely to achieve the NEO, NGO and the RPP. The Commission disagrees with suggestions that the level of guidance included in the draft rule makes the AER less likely to be able to achieve these objectives than were there less prescription. Equally, the Commission disagrees that more prescription is needed than that provided by the draft rule. Rather, the Commission is of the view that the right level of balance has been struck by providing a framework for how the regulator should perform its duties, while at no stage undermining the primacy of the overall allowed rate of return objective.

The Commission has attempted to bring together a number of characteristics into a common rate of return framework that addresses many of the deficiencies in the current frameworks. One of the criteria the Commission has applied to determine the best framework for the NER and the NGR includes allowing methodologies for parameters to be driven by principles and to reflect current best practice.

Providing high level, principled guidance to the regulator in performing its task is an appropriate role for the NER and the NGR. Further, it enhances regulatory accountability, transparency and predictability. Nonetheless, such guidance must not impede the estimation of a high quality rate of return estimate that uses all relevant evidence and methods. The Commission does not consider that a framework relying on a relatively mechanistic approach to estimating the rate of return will be best placed to achieve the NEO, NGO and the RPP.

Guidelines

Responses from many service providers expressed a desire for more certainty from the proposed new rate of return framework. This includes more detail being required from the rate of return guidelines, including requiring the regulator to state specific parameter values in the guidelines.

While the Commission supports the rate of return guidelines having as much detail as possible, it is concerned that the guidelines should not be seen as a determinative instrument for calculating the rate of return without reference to the determination or access arrangement process. The role of the guidelines is to provide stakeholders with an opportunity to engage with the regulator to determine how it will estimate the rate of return at the time of the regulatory determination or access arrangement. That is, they are more about providing service providers, investors and consumers with certainty on the methodologies of the various rate of return components and how the regulator will assess the relevant estimation methods, financial models, market data and other evidence in meeting the overall allowed rate of return objective.

The guidelines also provide the regulator with an opportunity to specify how it will deal with any unpredictable changes in market conditions at the time of any regulatory determinations or access arrangements. The Commission expects that the guidelines will provide service providers and other stakeholders with an ability to make a good estimate of the rate of return for particular businesses at particular points in time. The Commission recognises that the guidelines could allow this to occur in a number of ways, including through the way the methodologies are explained and/or by providing ranges of possible outcomes.

Continued reliance on CAPM

A major concern expressed in numerous submissions is that under the proposed changes the regulator would still be able to, in effect, make exclusive use of the CAPM when estimating a rate of return on equity. The Commission understands this concern is potentially of considerable importance given its intention is to ensure that the regulator takes relevant estimation methods, models, market data and other evidence into account when estimating the required rate of return on equity.

As discussed above, the Commission takes the view that the balance between flexibility and prescription has been adequately achieved in the final position rule. It would be counterproductive to attempt to prescribe a list of models and evidence, which would almost certainly be non-exhaustive and could lead to rigid adherence to them in a mechanistic fashion.

Similar problems exist with assigning weights that must be given to relevant estimation methods, financial models, market data and other evidence. In many circumstances it could be the case that the likelihood of achieving the NEO or the NGO may be increased by examining a range of methods and data and making judgements aided by, for example, the location and/or clustering and/or statistical precision of estimates. That is, formulaic rules such as giving particular methods a fixed weighting may not be the best way to assess the information.

4.4.2 Departure from the guidelines

The Commission has considered suggestions from the ENA and other service providers to strengthen the role of the guidelines. This would be through a requirement that the regulator (and service providers) to provide “reasons and evidence” or some other definable evidentiary threshold when seeking a departure from the guidelines.

The intention of the rate of return guidelines is *not* to be binding on either the regulator or the service provider. The role of the guidelines is to be distinctly different to how the existing Statement of Regulatory Intent (SORI) on WACC operates under the current Chapter 6 and 6A rate of return frameworks of the NER. The rate of return guidelines are not intended to explicitly lock-in any parameters or methodologies from which departure would not be permitted. In order for the guidelines to have some purpose and value at the time of the regulatory determination or access arrangement process, they must have some weight to narrow the debate. However, there should not be any "inertia principle" or "persuasive evidence test" applying to the application of the guidelines. Requirements on the regulator (and service providers) of this nature to justify departures from the guidelines would undermine the purpose of them.

To this end, the Commission's draft rule required the regulator to explain reasons for any departure from the guidelines in a regulatory determination decision and required service providers to explain reasons for any proposed departures from the guidelines in their regulatory submissions. The draft rule also required the regulator to have in place a rate of return guideline at all times after the publication of the first guidelines. This means that, under the Commission's draft rule, there would be a guideline in force to act as a reference point both for the regulator and the service provider at any point in time. In this respect, the Commission is satisfied that its draft rule achieved the intended purpose and therefore the final position rule reflects that approach.

4.4.3 Development of the guidelines

The Commission recognises that the preparation of the first rate of return guidelines will require extensive consultation. Therefore, the transitional arrangements for the implementation of the final rule will address the timeframes that would be required for the development of the first rate of return guidelines.

In the Commission's view, subsequent rate of return guidelines would likely involve more incremental changes in approach, and hence, the process may be shorter. Even where substantial changes are contemplated, these are likely to be limited to a small number of parameters and/or methodologies. If complex issues are identified and greater time is required for consideration, the regulator has the ability to extend the process for reviewing the guidelines. This flexibility was provided in the draft rule. For the final position rule, the Commission has retained the three-yearly review cycle for the guidelines so that they can be kept current and allow change to be more incremental. The Commission recognises that whenever the guidelines are being reviewed, there will be some service providers who will be required to submit their regulatory proposals at some point in the cycle.

In these circumstances, there could potentially be some uncertainty as to which version of the guidelines apply. However, the Commission is not convinced that mandating the application of the guidelines that was in force at the time of the framework and approach paper is the best way to deal with this uncertainty. Any mandated application of the rate of return guidelines undermines its flexibility and shifts the guidelines closer to a binding document.

A preferable way to address the issue is to retain the draft rule approach. This does not preclude the regulator from including in the new guidelines measures that provide certainty to those service providers that would be affected. Further, the draft rule provisions on the guidelines in the NER required the AER to consider transitional issues where there may be changes to regulatory approach in future determinations.[74]

The draft rule provisions therefore provided the AER with sufficient flexibility to consider how changes to its guidelines would impact on those service providers that would be required to submit their regulatory proposals during the course of the finalisation of the guidelines. It would not be appropriate for the rules to mandate which guidelines should apply to service providers in the transitory phase. This is because the extent and impact of any changes to the guidelines resulting from the periodic review will vary from review to review, depending on the issues that are raised. Therefore, it would seem appropriate to give the regulator the ability to determine which rate of return guidelines should be applicable in any individual case. As the guidelines are not binding, the AER can apply them flexibly to take into account such timing issues.

Ultimately the rate of return framework is about making the best estimate of the rate of return. While the guidelines plays an important role in the process as the point of departure for the regulator, service providers and other stakeholders at the time of a determination or access arrangement, whether a previous or recently revised version of the guidelines is used as the point of departure should not fundamentally affect the ultimate aim of making the best possible estimate of the rate of return.

For the final position rule, the Commission has not made any changes from the draft rule on this issue. However, the Commission acknowledges that no equivalent rule of NER clauses 6.2.8(d) and 6A.2.3(d) existed or was proposed in the draft rule for the NGR.[75] The final position rule for the NGR rate of return includes the equivalent NER clause for the AER and the ERA to consider transitional issues in making of the rate of return guidelines.

4.4.4 Nominal post-tax issues

Two specific issues were raised in response to the Commission's draft rule to prescribe the nominal post-tax approach. First, the ERA and some gas service providers did not support mandating the nominal post-tax approach, although on different grounds. Second, a number of submissions sought clarification of the definition of the nominal post-tax rate of return.

Prescribing a common approach

The Commission notes that there is widespread support among stakeholders to have a consistent and common rate of return framework across the three sectors covered under the NER and the NGR. However, the ERA and some gas service providers did not support mandating the nominal post-tax approach under the NGR, although on different grounds.

74 See draft rule NER clauses 6.2.8(d) and 6A.2.3(d).

75 See final position rule clauses 6.2.8(d) and 6A.2.3(d) of the NER that states that if a guideline indicates that there may be a change of regulatory approach in future determinations, the guideline should also (if practicable) indicate how transitional issues are to be dealt with.

In the draft rule determination the Commission observed that, from a theoretical perspective, the choice of nominal or real or post-tax or pre-tax treatment of rate of return estimate should make no difference to outcomes for service providers or consumers. This issue has arisen from the fact that the AER currently uses a post-tax nominal framework for estimating the allowed rate of return for electricity NSPs under the NER. In contrast, a number of gas service providers have historically had their allowed returns determined using a pre-tax real framework, particularly those that have been regulated by the ERA.

Furthermore, the ERA submitted in response to the consultation paper that it was supportive of the proposal to adopt a common framework using a nominal post-tax basis. However, since that time the ERA has developed a new approach based on a hybrid real post-tax revenue model. The ERA submits that its hybrid real post-tax revenue model has some advantages over the AER’s PTRM.

The ERA submits that, relative to the AER’s PTRM, its hybrid approach delivers:

- more regulatory revenue over the life of assets, as compared to the AER's approach;
- an identical present value of regulatory revenue as the full nominal approach under most circumstances over the life of the assets; and
- revenue that is aligned closely with the service providers 'actual' after tax position (as opposed to the regulatory tax position of the benchmark firm).

As a result, the ERA argues that the rate of return framework should also allow regulators the ability to adopt a rate of return approach which best reflects the efficiency objectives of the NGO. However, it is not clear that any of these differences would support the conclusion that the ERA’s hybrid approach better meets the NGO or the NEO, and the ERA submits only that “there is evidence to suggest that the best form of post-tax model remains open to question".

The Commission has sought advice from SFG in relation to this issue.[76] SFG notes the inconclusive nature of the ERA's view on how allowing alternative approaches to the nominal post-tax rate of return better meets the NGO. In SFG's view, there are a number of more compelling reasons to support retention of the draft rule approach. Specifically:

- the ERA submission does not suggest that the AER’s PTRM is in any way inconsistent with the NEO or the NGO;
- the ERA submission does compare and contrast the PTRM against its hybrid approach in terms of consistency with the NEO or the NGO;
- retaining the Commissions draft rule mandating a nominal post-tax approach achieves the much supported objective of a common rate of return framework across all sectors; and

76 SFG Consulting, *Response to submissions on rule change proposals*, Report for the AEMC, 5 November 2012.

- a significant majority of service providers under the NER and the NGR are already regulated by the AER under the PTRM.[77]

The AER has also responded to the ERA's submission on this issue, noting that the revenue differences identified by the ERA are driven by the adoption of specific modelling assumptions rather than whether a nominal rate of return or real rate of return framework is applied.[78] For example, the AER considers that the likely cause of the identified revenue differences are the result of employing different tax input modelling and cash flow timing assumptions between the AER's modelling approach and the ERA's modelling approach.[79]

After considering SFG's advice and AER's views, the Commission considers that at this point, there is insufficient evidence to conclude that allowing the flexibility of using approaches other than a nominal post-tax framework as sought by the ERA would necessarily lead to outcomes that better meet the NGO or the NEO.

It is evident that the differences in views have arisen because of certain modelling assumptions, rather than any fundamental economic requirement to have different approaches being applied to different service providers to determine their efficient revenues/prices. Since the majority of service providers under the NER and the NGR are already subject to the nominal post-tax approach as applied by the AER, it would be more practical to have a common approach already in place extend to all service providers. A common approach will mean that the rate of return can be compared on a consistent basis. Further, as the AER notes, it also avoids the need to direct resources to maintaining different revenue models that deliver the same outcome in terms of the underlying rate of return framework.[80] Consequently, the final position rule mandates the use of the nominal post-tax approach to rate of return under the NER and the NGR (see further below on clarification of the form of nominal post-tax approach).

The Commission has also considered comments from APIA that there may be some potential unintended consequence for those gas service providers requiring a transition from the real pre-tax basis to a nominal post-tax basis. APIA states that the nominal post-tax approach to a gas service provider's capital base will create a discontinuity in the cash flows. This is because of the implicit tax asset base under the pre-tax real calculations will not be the same as the capital base.

It is not the Commission's intention that gas service providers, or indeed consumers, face any unnecessary costs resulting from any transition from a real pre-tax approach. To the extent possible, the Commission would expect the impact on the limited number of gas service providers and their consumers from the change in approach to be neutral. In relation to the specific issue raised by APIA, advice from SFG indicates that there could potentially be a financial loss to a service provider due to expropriation of value from its asset base resulting from the change.[81] However, SFG did not suggest that this

77 Id., pp. 7-8.

78 AER, Draft Rule Determination supplementary submission, 25 October 2012, p. 1.

79 Ibid.

80 Id., p. 2.

81 SFG Consulting, *Response to submissions on rule change proposals* Report for the AEMC, 5 November 2012, pp. 9-11.

issue justifies not applying a common nominal post-tax approach. SFG suggests that this would be a transitional issue under a change of basis for determining the rate of return and could be dealt with by preserving the starting value of the affected gas service provider's capital base.[82]

Based on SFG's advice, the Commission agrees with APIA that some form of transitional provisions should be considered for those gas service providers that would be affected by a change from the real pre-tax approach to the nominal post-tax approach. While APIA has proposed a specific method for addressing the specific potential unintended consequence that they have identified, the Commission considers that a more general approach would be appropriate.

As discussed in section 4.4.3, the final position rule provides sufficient flexibility for the regulator to consider potential transitional issues either through the guidelines, or at the time of individual access arrangement reviews. The reason the Commission prefers leaving this issue for the regulator to address is that it is difficult to identify precisely what the impact will be on those gas service providers at this point in time. The potential effect will depend on the individual circumstances of the affected gas service provider and is better examined at the time of their access arrangement review to enable full consideration of the relevant information. As a result, through this general approach, the regulator could consider the transitory impact in greater detail when developing the rate of return guidelines and make any specific adjustments it considers appropriate tailored to the affected gas service provider at the time of its individual access arrangement decision.

On a related issue, the Commission notes that APIA has sought clarification that the actual tax position of the service provider is not relevant for the purposes of calculating tax. The Commission notes that the final position rule (and the draft rule and the existing rule) clearly requires the rate of return framework to be applied to a benchmark efficient firm and not to the particular position of the specific service provider being regulated. For example, while this would be strictly a matter for the regulator to determine in accordance with the overall allowed rate of return objective, the Commission expects that in the same way the regulator would need to estimate the gearing and credit rating values with reference to a benchmark efficient firm, tax liabilities would also be calculated with reference to a benchmark efficient firm. This would provide the particular service provider with an incentive to beat the efficient benchmark and an effective penalty if it does not.

Clarification on the intended nominal post-tax approach

In the draft rule, the Commission intended that the AER would continue to use the same definition of WACC as it currently does under its post-tax revenue model (PTRM), as required under the NER. Specifically, the Commission intended that the AER would continue to use the version of the post-tax nominal WACC that has become known as the “vanilla” WACC. To this end, the Commission adopted the same language in the draft rule as that which currently appears in Chapters 6 and 6A of the NER. However, it has become apparent that by removing the WACC formula that is specified in the existing Chapter 6 and 6A and retaining the "nominal post-tax"

82 Ibid.

reference in the rules has the unintended effect of creating ambiguity as to which form of WACC computation would be permissible.

As noted in SFG's advice on this issue:

> “[T]here are a number of different WACC formulas that can all be identified as post-tax nominal definitions of WACC. Officer (1994), in the paper that forms the basis for the regulatory rate of return framework, sets out four such definitions in the section of his paper titled “The after-tax cost of capital” (pp. 6-8). Each of these four definitions of the after-tax nominal WACC is coupled with a unique corresponding definition of the cash flows. The definitions of the after-tax nominal WACC differ in terms of whether the tax benefits of (a) the deductibility of interest payments, and (b) the assumed effect of dividend imputation tax credits are incorporated in the WACC or in the cash flows.[83]”

After considering the potential consequences of retaining the draft rule wording of "nominal post-tax", the Commission has amended the wording in this final position rule to clarify that the rate of return is to be determined a "nominal vanilla" basis. The final position rule will ensure that those service providers regulated by the AER under the NER and NGR will continue to have their rate of return estimated on the same "vanilla" WACC framework. However, as discussed in the section above, those gas service providers regulated by the ERA will be impacted by this and will need to be transitioned from the real pre-tax WACC.

4.4.5 Internal consistency and interrelationships

As with the draft rule, the final position rule requires the regulator to have regard to inter-relationships between financial parameters used in estimating the allowed rate of return.

A number of submissions have sought some clarification of the Commission’s intentions in relation to the requirement for the regulator to have regard to any interactions between parameters within a model. In particular, some submissions expressed a concern that if the allowance in relation to the return on debt were estimated on the basis of historical averages, the allowance in relation to the return on equity would also have to be estimated based on the same historical averages. This is not the Commission's intention.

If a historical average is used to estimate the allowance for the return on debt, there is no requirement for the resulting estimate, or any part of it, to constrain the estimate of the allowance for the required return on equity. The return on equity must reflect the prevailing conditions in the market as it is a forward-looking financial concept. The estimation of an historical average is a different exercise altogether, and one estimate does not constrain the other. For example, the historical average of the risk-free rate (as part of the return on debt estimation) and the contemporaneous risk-free rate (as part of the return on equity estimation) are different parameters that need not take the same value. The return on debt estimation is discussed in more detail in the next chapter.

83 SFG Consulting, *Response to submissions on rule change proposals* Report for the AEMC, 5 November 2012. p. 2.

The final position rule also requires that the return on equity estimation to have regard to the prevailing conditions in the market for equity funds. There is no corresponding requirement on the allowance for the return on debt, since the final position rule (and the draft rule) allows the return on debt to be estimated with reference to an historical average as well to the prevailing conditions in the market.

The final position rule makes clear the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt.

4.4.6 Benchmark efficiency

Under the Commission's final position rule, the regulator must determine a rate of return that is consistent with that required by a benchmark efficient firm with similar risk characteristics to the service provider in question.

The Commission believes that the concept of efficiency and the benchmark characteristics that relate to the risk of service providers should be left to the regulator to determine. It would be inappropriate for the NER and NGR to seek to define either the concept of efficiency or prescribe what the risk and benchmark characteristics should be.

The NEL and the NGL themselves do not seek to define efficiency in terms of the NEO and the NGO respectively. Including a particular definition in the NER and the NGR risks constraining the regulator's ability to make the best possible decisions.

Furthermore, the concept of a benchmark service provider and the risks that a benchmark service provider may face are not rigidly static and can change over time. As a result, it would be impossible to list all relevant characteristics in the NER and NGR and expect them to remain appropriate. The Commission is of the view that the regulator and the industry should have an opportunity to discuss these matters periodically and make incremental changes to what constitutes a benchmark service provider as the risk profile changes. The periodic review of the rate of return guidelines provides the ideal forum for such matters to be examined in detail.

4.4.7 Departure from NSP's proposal

The Commission has given further consideration to whether or not the rate of return decisions should be subject to the constituent decision constraints of the NER. These constraints relate to the AER's ability to substitute any amount or value on the basis of the NSP's regulatory proposal and amended from that basis only to the extent necessary to enable it to be approved in accordance with the rules.[84]

The ENA and other NSPs have not made a sufficient case as to why such a restriction should apply to constrain the AER's ability to determine the rate of return with reference to the NSP's regulatory proposal. Instructively, such a requirement does not exist in the NGR and gas service providers have not sought to have such a requirement included in the rate of return framework.

84 See NER clauses 6.12.3(f) and 6A.13.2(a).

The AER's rate of return decision made at the time of the NSP's regulatory determination would be informed by its decisions in the rate of return guidelines and an assessment of evidence and market conditions at the time of the individual regulatory determination. This would include any reasons for departure from the guidelines provided by the NSP in its regulatory proposal. In order for the AER to make a decision on rate of return that best meets the overall allowed rate of return objective, by necessity the AER must have the flexibility to consider information beyond that which is provided by NSPs in their proposals.

Furthermore, it is somewhat perplexing for NSPs to suggest that the AER should only limit its assessment of the rate of return with reference to whatever rate of return proposal NSPs make. Considerable comments have been made about the rate of return being a benchmark concept that is only relevant to any individual NSP to the extent that the assumed risks of the benchmark firm reflects the similar risk characteristics to the service provider.

The Commission's final position rule clearly specifies that the allowed rate of return must meet the overall rate of return objective. In order for its final position rule on the rate of return framework to work as intended under the NER, the AER should not be limited to assessing a rate of return proposal on the basis of what the service provider proposes, with any departure from that proposal being the minimum necessary for the rate of return to comply with the requirements set out in the NER.

The Commission has determined that these clauses should not apply for rate of return decisions. In addition, as section 6.4.1of this final position discusses, the Commission has determined that the restrictions these clauses place on the regulator in general are not appropriate, and has removed them from the NER altogether.

4.4.8 Other issues

The Commission has decided not to reference "prevailing conditions in the market for funds" in the overall rate of return objective. This is because the objective would then be in conflict with the allowance for the return of debt where it is estimated on a trailing average basis. The Commission considers that it is clear from the return on equity provisions that the "prevailing conditions" concept continues to apply there, and that it also does apply, to the extent possible, for the return on debt estimation.

Also, references to "prevailing conditions" are not meant to exclude from any consideration historical or realised returns. However, the Commission does not consider that any drafting changes to the draft rule are required for the final position rule to give effect to this. The final position rule (as with the draft rule) is drafted in sufficiently broad terms to allow for such financial concepts to be taken into account for the purposes of developing appropriate estimation methodologies.

In response to stakeholders concerns, the Commission has substituted the words "correspond to" in the draft rule allowed rate of return objective with "commensurate with" in the final position rule. While the approach behind the use of "correspond to" in the draft rule was to make the wording plain English, the Commission recognises that "commensurate with" is well understood, and has been applied without an issue in the past. There is benefit in retaining existing terminology. For the avoidance of doubt, the Commission intends "commensurate with" to mean that the rate of return can only ever be estimated as a reasonable approximation rather than identified with total precision. Whether or not the estimated rate of return meets the allowed rate of return objective will invariably require some level of judgement, but this judgement should be based with reference to all relevant estimation methods, financial models, market data and other evidence that could reasonably be expected to inform a regulator's decision.

4.5 Guidance on final position rule

This section covers aspects of the final position rule on the rate of return framework other than the return on debt, which is discussed in chapter 5.

The final position rule provides a common rate of return framework for determining the return on capital for service providers. In determining the return on capital, the allowed rate of return would be estimated at the time of each regulatory determination of a TNSP or DNSP and each access arrangement decision of a gas service provider.

The final position rule is structured to require the regulator to determine a rate of return consistent with an overall objective (the allowed rate of return objective). The allowed rate of return objective requires the rate of return to be commensurate with the efficient financing costs of a benchmark efficient service provider with similar degree of risk to the service provider whose rate of return is being determined.

The allowed rate of return objective incorporates the concept of a benchmark efficient service provider, which means that the regulator can conclude that the risk characteristics of the benchmark efficient service provider are not the same for all service providers across electricity transmission, electricity distribution and gas and/ or within those sectors. The Commission would expect a regulator in developing its guidelines (discussed below) to explicitly consider this issue. Having said this, the Commission recognises that if a regulator concluded that the risk characteristics of a benchmark efficient service provider are different between, for instance, electricity and gas service providers, there may be challenges in all cases in identifying sufficiently precise measurements of the quantum of the difference for determining the rate of return.

In determining the allowed rate of return, the regulator would be required to consider the return on equity and the return on debt as the allowed rate of return comprises a weighted average these two components. Although, for practical purposes, the regulator may turn its mind to separately estimating the return on equity and return on debt, the Commission considers that the process is a joint estimation exercise and that the regulator must ensure that the overall estimate of the rate of return satisfies the overall objective.

To determine the rate of return, the regulator is also required to have regard use relevant estimation methods, financial models, market data and other evidence. The intention of this clause of the final position rule is that the regulator must consider a range of sources of evidence and analysis to estimate the rate of return. In addition, the regulator must make a judgement in the context of the overall objective as to the best method(s) and information sources to use, including what weight to give to the different methods and information in making the estimate. In doing so, the regulator should also have regard to taking an internally consistent approach and, to the greatest extent possible, use consistent estimates of values that are common across the process, as well as properly respecting any inter-relationships between values used.

The final position rule requires the allowed rate of return to be determined on a nominal vanilla WACC basis with proper regard to dividend imputation (gamma). This is also consistent with the existing WACC approach in the NER rate of return frameworks in that it requires a consistent treatment of cash flows and the discount rate to properly incorporate the gamma factor. The current prescription of the gamma value of 0.5 in clause 6A.6.4 has also been removed to allow the regulator the ability to estimate an appropriate value that reflects the best available evidence at the time of a decision and would therefore result in a rate of return that meets the overall objective.

In addition, since the vanilla version of the nominal post-tax rate of return framework will apply to gas service providers under the NGR, the Commission's final position rule includes new provisions for the estimation of the cost of corporate income tax. This provision is similar to the provisions in Chapters 6 and 6A of the NER to allow for a common rate of return framework to be established. Furthermore, the Commission expects the regulator to address any transitional provisions for service providers that have had a basis other than a nominal post-tax basis for the rate of return. Any transitional adjustment required with the change in basis should seek to achieve a neutral financial impact on the affected service provider and consumers.

The final position rule distinguishes between the allowed rate of return objective (ie the rate of return must be commensurate with the efficient financing costs of a benchmark efficient entity with similar degree of risk to the service provider whose rate of return is being determined) and other requirements that the regulator must have regard to.

The final position rule has been structured in such a way as to reinforce the focus of the estimate of the rate of return to be on the achievement of the allowed rate of return objective. Estimating the return on equity and return on debt are likely to be necessary components to determine the overall rate of return that meets the overall objective. However, as achieving the overall objective has primacy the regulator would need to consider the overall estimate against the overall objective and not just add together and weight its estimates of the cost of equity and debt. Guidance has been provided in estimating both these components through factors that the regulator must have regard to.

In light of comments from stakeholders, the Commission has reordered the drafting from the draft rule in the final position rule to better group the factors that should be considered as part of the determination of the rate of return that meets the overall objective. There is no change as to the intended operation of these clauses. While the final position rule gives the regulator discretion in the factors it must have regard to, the Commission considers that the regulator must undertake the rate of return estimation process with rigour and transparency. In this regard, the Commission expects the regulator to use estimating practices that are robust and rely on transparent data sources. It is also expected that the regulator will clearly articulate how it has considered the factors it must have regard to in making its decision on the allowed rate of return that meets the overall objective. The role of factors that the regulator must have regard to or take into account in achieving the objective is more generally discussed in section 3.5

There was some confusion from stakeholders on the draft rule's use of "have regard to and "take into account" in the drafting structure for the new rate of return provisions. The Commission's view on this issue is also discussed in section 3.5.

Estimating return on equity

The final position rule sets out two requirements for the return on equity estimation. The first is that the estimation must contribute to achievement of the allowed rate of return objective. The second is that the estimation have regard to the prevailing conditions in the market for equity funds.

The Commission has taken the view that it is preferable not to prescribe in the rules a list of particular models that should be considered or indeed prescribe characteristics that must be met by such a model. The Commission instead is requiring that the regulator have regard to relevant estimation methods, financial models, market data and other evidence and is leaving to the judgement of the regulator the relative weights to be given to methods, models and such information. Implicit in this requirement to consider a range of methods, models and information is that checks of reasonableness will be undertaken.

The second principal requirement is that the return on equity must take into account the prevailing conditions in the market for equity funds. It reflects the importance of estimating a return on equity that is sufficient to allow efficient investment in, and efficient use of, the relevant services. However, this requirement does not mean that the regulator is restricted from considering historical data in generating its estimate of the required return on equity. Rather, it ensures that current market conditions are fully reflected in such estimates to ensure that allowed rates are sufficient for efficient investment and use. In summary, the regulator must make its estimate in a way that contributes to the achievement of the overall objective and in doing so must have regard to the prevailing conditions in the market for equity funds.

Rate of return guidelines

The Commission expects the regulator to develop the rate of return guidelines with the intention to allow a more focussed discussion on wider issues around estimating the rate of return, including the choice of estimation methods, financial models, market data and other types of information that may be used, and how the regulator intends to apply them. This includes guidance from the regulator on how it proposes to deal with any new information or evidence at the time of the regulatory determination. The Commission also expects the regulator to widely engage with stakeholders, including consumers and consumer representative groups.

These guidelines must be reviewed at least every three years in accordance with the defined consultation procedures. The final position rule requires the AER to develop separate guidelines for service providers in the electricity transmission, distribution and gas sectors, though the intention of the Commission is to allow the AER to undertake a common process to the extent possible (and appropriate) for developing the guidelines.

In developing and reviewing the guidelines, the final position rule requires the AER to follow the consultation procedures under Chapters 6 and 6A of the NER. The Commission's preference is for the distribution consultation procedures to apply both for TNSPs under Chapter 6A and DNSPs under Chapter 6 of the NER. Since the transmission consultation procedures differ in some respects from the distribution consultation procedures, the Commission's final position rule amends the transmission consultation procedures to align them with the distribution consultation procedures, so as to allow the AER to undertake the review of the guidelines for TNSPs and DNSPs jointly and concurrently.

In addition, the final position rule introduces a new rate of return consultative procedure in Part 3 of the NGR for the development and review of the rate of return guidelines. This provision mirrors the distribution consultation provisions of the NER. The NGR rate of return consultative procedure provisions will allow the AER to develop and review the guidelines under the NGR at the same time as under the NER. The ERA would also be required to produce separate guidelines for the gas service providers it regulates under the NGR through the new rate of return consultative procedure provisions.

The Commission expects that the creation and periodic review of the rate of return guidelines will involve a wide and thorough consultation with stakeholders. The consultation procedure timeframes are the minimum required under the rules and it is expected that the regulator will use the ability in the consultation procedures to extend the minimum consultation periods to provide stakeholders with an adequate opportunity to respond to any complex or significant issues that arise in any review period.

The Commission expects the guidelines to provide a detailed outline of the methodologies to which the regulator proposes to have regard in determining the rate of return. That is, within the guidelines the regulator would be expected to:

- detail the financial models that it would take into account in its decision, and why it has chosen those models rather than other models. This would extend to outlining its methodologies, estimation techniques and current estimates (where appropriate) of relevant parameters;
- detail any other information that it would expect to have regard to, and why it has chosen to have regard to that information and not to other information;
- provide guidance on how it would use such models and information in reaching its decision, including matters such as:
  - the relative weight (although not necessarily in a quantitative way) it would expect to place on various model estimates; and
  - what market data (or similar) it would use to ascertain lower bounds and/or reasonableness checks on the estimates;
- incorporate best practice in the application of financial models and market data; and
- be as transparent and open as possible.

In keeping with the Commission's objective of limiting unnecessary prescription, these guidelines will be non-binding. Though the guidelines will not be binding in the same way the current SORI is under the Chapter 6 and 6A rate of return frameworks, the Commission would expect service providers, consumers, the AER, the ERA, and the appeal body to have significant regard to them as a starting point for each regulatory determination or access arrangement. The Commission is of the view that the regulator should be allowed a fair degree of flexibility on the precise contents of these guidelines, but intends the guidelines to provide a meaningful signal as to the regulator's intended methodologies for estimating return on equity and return on debt components of the allowed rate of return. The guidelines should not be seen as a determinative instrument for calculating the rate of return.

The Commission anticipates that the guidelines would allow a service provider or other stakeholder to make a reasonably good estimate of the rate of return that would be determined by the regulator if the guidelines were applied. In other words, the methodologies to be adopted and the information sources to be used should be sufficiently well explained such that they could be applied with a reasonable degree of certainty and accuracy. The Commission considers that this could be achieved in a number of ways, including by providing indicative ranges for the rate of return estimate for particular types of service providers or through the way the approach to the estimate is explained.

The application of the rate of return guidelines at the time of a regulatory determination or an access arrangement decision is not mandatory. However, if the regulator makes a decision on any methodology for estimating the allowed rate of return that is not in accordance with the guidelines, the regulator must state, in its reasons for the regulatory determination or access arrangement decision, the reasons for departing from the guidelines.

The final position rule places a similar obligation on the service providers. That is, a service provider must have regard to the most recent rate of return guidelines when proposing a rate of return as part of its regulatory proposal. However, where the service provider seeks to depart from the methodologies in the guidelines, it must state in its regulatory proposal the reasons for departing from the guidelines. The Commission expects that, in developing and reviewing the guidelines, the regulator will address any transitional issues for service providers who have either commenced their regulatory determination process or are close to finalising their regulatory proposal during the period when the guidelines are reviewed and updated.

5 Return on debt

Summary

- Consideration of return on debt methodologies other than the current prevailing market conditions approach has received broad support from stakeholders. Historical trailing average approaches have sufficient merit to be an option for regulators to consider.
- The best methodology for estimating return on debt may not be the same for benchmark efficient service providers with different characteristics. Therefore, the rules should not prescribe a particular methodology for estimating the return on debt component. However, the rules should provide some guidance as to how the best methodology should be determined. The rate of return guidelines will provide a forum to discuss and analyse the best approaches to estimating the return on debt.
- The Commission has not made a rule that would put in place a different approach to estimating the return on debt for privately-owned and state-owned service providers as proposed by the EURCC. The fundamental premise behind this proposal, that state-owned service providers borrow funds in debt capital markets at rates lower than comparable private-owned network service providers, is not correct. It is the treasury corporations of the respective state governments who are able to borrow at rates lower than the private sector due to their ability to issue government guaranteed bonds.
- The most appropriate benchmark to use in the regulatory framework for all service providers, regardless of ownership in general, is the efficient private sector service provider. If state-owned businesses issued their own bonds, without a government guarantee, they would face materially similar borrowing costs to privately-owned service providers. In the absence of competitive neutrality provisions, electricity consumers are unlikely to be better off from defining a separate benchmark for state-owned service. The most appropriate benchmark to use in the regulatory framework for all service providers, regardless of ownership in general, is the efficient private sector service provider.

Difference between draft rule and final position rule

- The final position rule largely reflects the position the Commission took in developing its draft rule. However, the criteria that the regulator must have regard to when considering the best methodology to estimating the return on debt have been refined in the final position rule to better give effect to the Commission's intention.

5.1 Introduction

The existing Chapter 6 and 6A rate of return frameworks under the NER require weights to be applied to the return on equity and the return on debt to estimate the average return on capital. The weights are applied according to the gearing ratio – the relative proportions of equity and debt finance. The return on debt estimate represents the return that investors of debt capital would require from a benchmark efficient service provider. Aligning the return on debt estimate with the efficient expected cost of debt of a service provider is therefore an important element in determining the rate of return.

As the return on debt is part of the overall allowed rate of return, the Commission considers that the best way to meet the NEO, the NGO and the RPP for estimating the return on debt is the same as that discussed in the rate of return framework chapter. That is, the return on debt estimate should reflect the efficient financing costs of a benchmark efficient service provider. It should try to create an incentive for service providers to adopt efficient financing practices and minimise the risk of creating distortions in the service provider's investment decisions. If a service provider is run inefficiently then its shareholders, and not its customers, should bear the financial consequences of inefficient financing practices.

Under the current Chapter 6 and 6A of the NER, the return on debt is defined to be the nominal risk free rate plus the debt risk premium (DRP).[85] No such definition exists in the NGR. While the NGR does not mention the DRP, it states that the rate of return for gas service providers is to be commensurate with prevailing conditions in the market for funds and the risk involved in providing reference services.[86]

A more detailed discussion on the application of the current rules on return on debt, including the risk free rate and the DRP, was provided in the directions paper.[87] It also explained the rule change requests from the AER and the EURCC on return on debt that have been consolidated by the Commission.[88]

The remainder of this chapter is structured as follows:

- Section 5.2 summarises the Commission's position in the directions paper and draft rule determination;
- Section 5.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 5.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- Section 5.5 provides guidance on the final position rule.

5.2 Directions paper and draft rule determination

5.2.1 Options to use different methodologies

In the lead up to the draft rule determination, the AEMC undertook extensive consultation with stakeholders on the merits of allowing the rate of return to consider a

85 NER clauses 6.5.2(b) and 6A.6.2(b).

86 See NGR rule 87(1).

87 See AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, pp. 97-98.

88 Id., pp. 98-101.

historical trailing average approach to estimating the return on debt. The Commission noted the widespread, though not unanimous, support for consideration of a historical averaging approach.[89] A case was made, for example by the QTC, New South Wales Treasury Corporation (NSW T-Corp) and Ausgrid, that the current regulatory position of calculating interest rates on debt over a 20 to 40 day period encourages risk management behaviour in service providers that, in general, would not likely occur in the absence of such regulation. They argued that it also comparatively disadvantages large service providers whose ability to hedge large volumes of interest rate risk over such a short period is severely limited by the size and liquidity of the relevant markets.[90] The Commission also noted that submissions against the introduction of an averaging approach were based on arguments that such an approach would not properly reflect service providers' efficient financing and risk management strategies.[91]

To inform its analysis, the Commission engaged SFG to advise on the potential impacts of adopting a historical trailing average approach to estimating the return on debt. SFG was asked to consider the impact on the risks faced by the shareholders of the service providers and the impact on the incentives for service providers to undertake efficient capex. It is in these two ways that the introduction of a trailing average approach to estimating the return on debt could lead to more efficient outcomes to the benefit of consumers.[92]

In its report, SFG highlighted that for a given definition of the return on debt for an efficient benchmark service provider (in particular, the assumed credit rating and term to maturity) the average cost of debt will be the same over the long run. This is regardless of whether the return on debt estimate is based on the prevailing debt cost spot rate or an average of that spot rate.[93] Changing to an averaging approach will not, in itself, systematically reduce or increase the allowed return on debt in the long run. SFG observed that averaging approaches will, by definition, result in smoother estimates of the return on debt over time.[94]

SFG was also requested to provide analysis of a number of different approaches to implementing a trailing average approach to estimating the return on debt that covered the range of approaches proposed during the rule change process. The options analysed

---

89 See for example, ENA, Directions Paper submission, 16 April 2012, p. 56; Energex, Directions Paper submission, 16 April 2012, p.3; Ergon Energy, Directions Paper submission, 16 April 2012, pp. 13-14; Grid Australia, Directions Paper submission, 16 April 2012, p. 2; Ausgrid, Directions Paper submission, 16 April 2012, p. 13; UE and MG, Directions Paper submission, 16 April 2012, p. 11; MEU, Directions Paper submission, 17 April 2012 , p. 32; EUAA, Directions Paper submission, 17 April 2012, pp. 31-32.

90 QTC, Directions Paper Submission, 16 April 2012, p. 7; NSW T-Corp, Directions Paper submission, 16 April 2012, p. 3; Ausgrid, Directions Paper submission, 16 April 2012, p. 13.

91 See for example, APIA, Directions Paper submission, 16 April 2012, pp. 20-21; APA Group, Directions Paper submission, 16 April 2012, p. 6.

92 SFG Consulting, *Rule change proposals relating to the debt component of the regulated rate of return*, Report for the AEMC, 21 August 2012.

93 Id., p. 4.

94 Id., p. 5.

by SFG took account of the proposed approaches of EURCC,[95] the QTC[96] and SA Power Networks (previously ETSA Utilities), CitiPower and Powercor.[97] SFG compared these approaches to the current approach, defined as an estimate of the return on debt for a service provider estimated at the time of each regulatory determination or access arrangement over a 20 to 40 day rate setting period. SFG's analysis isolated the impact of introducing different forms of a historical trailing average approach from the impact of different benchmark specifications for estimating the return on debt.

SFG also noted that the approach to setting the return on debt by the regulator cannot occur without regard to the service provider's financing practices. In particular, SFG considered that the regulatory framework should aim to provide incentives for service providers to engage in efficient financing practices. It should also seek to minimise distortions to the financing practices as well as to the incentives to undertake efficient capex.

In summary, SFG concluded that:

- The introduction of historical trailing average approaches for estimating the return on debt has the potential to reduce the risks faced by equity holders of some service providers. This is because a historical trailing average approach can allow a service provider to more closely match its debt servicing costs to the regulatory allowance for the return on debt.
- Currently service providers have varying abilities to match their debt servicing costs to the regulatory allowance for the return on debt. Some of the smaller privately-owned service providers appear able to hedge their interest rate very well, but larger state-owned service providers such as those in NSW and Queensland appear unable to enter into these hedges because the relevant financial markets are not sufficiently deep to meet their requirements. The reduction in risks for equity holders of moving to an historical trailing average approach is greater for those least able to currently match their debt servicing costs to the regulatory allowance. For those able to achieve a good match currently the introduction of a trailing average approach may slightly increase the risks for equity holders.
- A historical trailing average approach to estimating the return on debt can lead to significant differences between the regulatory allowance for return on debt and the cost of debt in the market for funds at any point in time. Such a difference could impact the incentives for service providers to invest efficiently in capex. For example, if the cost of debt in the market for funds is higher than the regulatory allowance then the service provider may not invest as much as would be efficient.

---

95 A method based on a five-year rolling average of the yield on five-year bonds, with annual updates during each regulatory period, no specified transition arrangements.

96 A method based on a ten-year rolling average of the yield on ten-year bonds, annual updates, transition arrangements, and provision for capital expenditure to earn a return based on the prevailing rate and not the historical average.

97 A method based on a ten-year rolling average of the debt risk premium on ten-year corporate bonds added to the five-year swap rate at the time of the determination.

SFG noted that the QTC's proposal for a historical trailing average return on debt provided one way to address this risk.

- Service providers are likely to have entered into financial arrangements to mitigate their risk given the current approach to estimating the return on debt. Therefore, any change in approach could lead to some service providers gaining extra revenue or losing revenue as a result of unwinding those financial arrangements. Gains or losses of revenue of this type from changes in regulatory arrangements could be perceived by investors as increasing regulatory risk, and thereby lead investors to seek a higher rate of return. SFG therefore recommend that consideration be given to transitional arrangements when changing the approach to estimating the return on debt.

In its draft rule determination, the Commission noted that the apparent diversity of stakeholder views was consistent with modelling analysis from SFG. It suggests that, for service providers with significant refinancing risks, the cash flow volatility of equity returns can be substantially reduced by moving to a trailing average approach. However, for others, the current prevailing rate approach is slightly better at minimising the volatility of returns.[98]

In its draft rule determination, the Commission considered that the long-term interests of consumers would be best served by ensuring that the methodology used to estimate the return on debt reflects, to the extent possible, the efficient financing and risk management practices that might be expected in the absence of regulation. In its draft rule, the Commission therefore proposed to make it unambiguous that the regulator can consider a range of approaches to estimating the return on debt to meet the overall rate of return objective. This would include a range of different approaches that involved using a "spot rate" methodology that used market data to reflect prevailing conditions in the market for funds or averaging estimates of the return on debt over historical periods, or some combination thereof.

The draft rule did not set the return on debt by reference to any particular base rate and DRP. The Commission took this view to allow the regulator sufficient flexibility to determine historical averages of either the entire return on debt or just the DRP component. Furthermore, the Commission's intention was to ensure that there is the flexibility to set a DRP against a base rate other than the Commonwealth government bond rates (eg bank bill swap rates), if that was considered appropriate by the regulator. The Commission considered this flexibility to be important to allow the methodology used to estimate the return on debt to reflect the borrowing and risk management practices of an efficiently run service provider.

The Commission also noted that regulators in some overseas jurisdictions have adopted similar approaches to the type of historical trailing average approaches that were discussed during this rule change process. For example, Ofgem, as part of its transmission and gas distribution price controls to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model, has applied an index to the return on debt allowance. Ofgem has noted that indexation, in and of itself, does not preclude

98 SFG Consulting, *Rule change proposals relating to the debt component of the regulated rate of return*, Report for the AEMC, 21 August 2012, pp. 52-68.

regulated businesses from entering into any particular hedging strategy. Also, indexation ensures that efficiently financed debt is funded, even if the market cost of debt is above the return on debt allowance at the time of debt issuance.[99]

The Commission's draft rule proposed some factors that the regulator must have regard to when considering the approach to estimating the return on debt. The purpose of these factors was to identify some factors that the Commission considered should be had regard to when the regulator considers the best methodology to use to estimate the return on debt, and if the service provider wants to propose a different methodology. The regulator is only required to have regard to the factors and the consideration of the factors is sub-ordinate to the regulator's estimate of the rate of return aiming to meet the overall rate of return objective.

Amongst such factors was the extent to which a particular approach to estimating the return on debt may affect the required return on equity for a service provider. If a particular approach to estimating the return on debt can reduce the refinancing risk of an efficiently financed service provider, then there may be scope to conclude that the return on equity should be lower than it otherwise would have been. Such an outcome would be to the benefit of consumers.

The impact on the incentives for efficient capex is also an important consideration. The incentives for efficient capex are stronger when the difference between the return on debt and the debt servicing costs of the service provider is minimised.

5.2.2 Specification of benchmark characteristics

In the directions paper the Commission sought views on the appropriate benchmark to use for estimating the return on debt. Given the evidence, in the draft determination the Commission considered that the regulator is best placed to assess the characteristics of a benchmark efficient entity consistent with the overall rate of return objective. Therefore, the Commission did not reach a view on whether the characteristics the regulators have used to define the benchmark were appropriate. Under the Commission's draft rule on the rate of return framework, the regulator would need to consider this issue as part of developing its rate of return guidelines, and that process will provide an opportunity for all stakeholders to submit their views and discuss any differences of view.

Separately, the Commission considered how to measure the return on debt for particular characteristics of a benchmark efficient service provider. In this respect, the draft rule did not mandate the use of any particular measurement approach. The Commission was of the view that this flexibility would give the regulator the ability to consider the best information and evidence to inform such a measurement.

5.2.3 Return on debt for state-owned service providers

In the directions paper the Commission explained its preliminary view that it was not minded to adopt the EURCC's proposal that the return on debt for state-owned service providers be set differently than for investor-owned service providers.

99 Ofgem, *Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Financial issues*, 31 March 2011.

A different view was taken to the EURCC on the application of the Competition Principles Agreement (CPA). Specifically, how the competitive neutrality principles to state-owned service providers are applied and the ability of the NER to legally affect the ability of jurisdictional governments to levy debt neutrality fees in accordance with the CPA.

Under the CPA, competitive neutrality principles must be applied by governments, where appropriate, to all significant state-owned businesses, including at the local government level.[100] The CPA also imposes a set of obligations on all governments in relation to taxation, debt and regulatory neutrality, full cost attribution and setting prices to earn a commercial rate of return.

Contrary to the EURCC's contention, the Commission's view was that the application of the CPA to state-owned service providers is not a relevant consideration under the NEO. Interpretation and application of the CPA is a matter for the state and territory governments who are signatories to it, and not the Commission. All jurisdictional governments that own service providers in the NEM apply the competitive neutrality principles to them as part of discharging their obligations under the CPA. Accordingly, each jurisdiction that has retained ownership of service providers has corporatised them and imposed similar commercial and regulatory obligations to those faced by the private sector, including:

- full Commonwealth, State and Territory taxes or tax equivalent payments;[101]
- commercial rate of return requirements and an obligation to pay dividends;
- requirements that prices reflect the full cost of providing network services;
- debt guarantee charges to offset cost advantages of implied government borrowing guarantees; and
- regulations applying to private sector competitors.

The most important factor to recognise is that state-owned service providers that are subject to the NER are required to pay debt neutrality or government guarantee fees to the jurisdictional government (via their state treasury corporations) as part of the application of the competitive neutrality principles. These fees are mandated in various state legislation and code of practice instruments.

The extent to which the debt neutrality or government guarantee fees are payable by state-owned network service providers is a policy matter for each jurisdictional government under the Competition Principles Agreement. In the draft determination the Commission also set out a number of other reasons as to why it would not be appropriate to set the return on debt allowance for state-owned network service providers differently to privately-owned network service providers. Briefly, some of the reasons include:

- the adoption of competitive neutrality principles can encourage greater commercial discipline on state-owned service providers. It will mean, for

100 Competition Principles Agreement subclause 3.(1).

101 For example see sections 128 and 129 of the *Government Owned Corporations Act 1993* (Qld); section 15 of *State Owned Corporations Act 1989* (NSW); section 6 of the *Electricity Companies Act 1997* (Tas).

example, that state-owned service providers are better informed about the true standalone cost of borrowing in the debt markets, allowing for improved decisions on whether to borrow funds to undertake capex or pursue non-network solutions. The debt neutrality fees play an important role in ensuring that state-owned service providers do not face artificially lower cost of capital that may distort their investment decisions;

- it will potentially create artificial geographical market distortions in generation and network capacities across the NEM because of the pricing signals that would be created due to network ownership;
- it risks distorting the incentives of efficient capital financing structures of state-owned network service providers compared to privately-owned service providers. In such circumstances, there is likely to be a material impact on consumers as ownership changes are considered; and
- the separate roles of shareholders and taxing authority where governments are also the owners of the service providers.

5.3 Submissions

5.3.1 Options to use different methodologies

The Commission's draft rule determination to allow different methodologies to estimate the return on debt under a flexible rate of return framework received widespread support. However, submissions from service providers expressed concerns that, under the draft rule, a new methodology could potentially be imposed on them by the regulator that could be unsuitable to their financing practices. They argue that the choice of methodology should not be at the sole discretion of the regulator.[102] The main arguments they make in relation to this are that:

- some service providers' debt portfolios may make a trailing average approach untenable;[103]
- a one-size-fits-all approach is inappropriate and the rules need to be flexible enough to accommodate different approaches across different service providers;[104] and
- service providers are better placed to judge optimal debt management strategies.[105]

102 See, for example, ENA, Draft Rule Determination submission, 4 October 2012, pp. 22-27; QTC, Draft Rule Determination submission, 4 October 2012, p. 11; APIA, Draft Rule Determination submission, 4 October 2012, p. 17; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 3; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 16; APA Group, Draft Rule Determination submission, 4 October 2012, p. 3; Ergon Energy, Draft Determination submission, 7 October 2012, pp. 5-6.

103 See, for example, DBP, Draft Rule Determination submission, 9 October 2012, pp. 4-5; The FIG, Draft Determination submission, 4 October 2012, pp. 20-21.

104 See, for example, ENA, Draft Rule Determination submission, 4 October 2012, pp. 23-25;The FIG, Draft Determination submission, 4 October 2012, pp. 20-21;APIA, Draft Rule Determination submission, 4 October 2012, p. 17.

The MEU is concerned that allowing service providers to seek a different return on debt estimation methodology, rather than having it imposed unilaterally by the regulator, would allow for "gaming" by the service providers.[106]

Another key issue of concern for stakeholders is the criteria or factors proposed by the Commission for assessing the appropriate approach for estimating the return on debt. The QTC submits that it agrees broadly with three of the criteria but one of them is unnecessary.[107] APIA suggests that the factors are duplicative of the requirements of the NGO and RPP and create either ambiguity or "double legislation" and are therefore redundant and should be removed.[108] The ENA submits that the criteria do not provide adequate guidance to the regulator and some are unlikely to be consistent with the NEO, NGO and RPP.[109]

In particular, the ENA is concerned that some of the factors in the criteria:

- are ambiguous and the AEMC's stated intention has not translated to the rules;
- appear to be conflicting and do not provide any guidance as to how conflicts between them are to be resolved;
- does not include any measures to ensure service providers are afforded a reasonable opportunity to recover benchmark debt costs over the long term; and
- do not require the regulator to take into account legitimate business interests around transition and changes in methodology after transition.[110]

The ENA suggests that clearer rules-based guidance is essential.[111] There is also a suggestion from some service providers that a higher level of prescription be included in the rules. For example, this should extend to setting out the form of debt (BBB+ Australian corporate bonds) and should include more directly relevant criteria against which to assess the proposed methodology.[112]

In a similar vein, there are also calls from some stakeholders that the rules should set out some details (eg benchmark gearing, credit rating, maturity) that the regulator should have to address in the rate of return guidelines.[113] The QTC suggests that given the relationship between efficient debt strategies and efficient debt costs, the guidelines should describe the main characteristics of efficient debt funding and risk management strategies for infrastructure service providers.[114] These characteristics would then need

105 See, for example, APIA, Draft Rule Determination submission, 4 October 2012, p. 17; ENA, Draft Rule Determination submission, 4 October 2012, p. 25; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 16.

106 MEU, Draft Rule Determination submission, 4 October 2012, p. 18.

107 QTC, Draft Rule Determination submission, 4 October 2012, p. 9.

108 APIA, Draft Rule Determination submission, 4 October 2012, p. 16.

109 ENA, Draft Rule Determination submission, 4 October 2012, p. 26.

110 Id., pp. 22-23.

111 Id., p. 23.

112 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 17.

113 ENA, Draft Rule Determination submission, 4 October 2012, p. 25.

114 QTC, Draft Rule Determination submission, 4 October 2012, p. 8.

to be taken into account by the regulator when assessing a proposal and for determining the benchmark.[115]

5.3.2 Specification of benchmark characteristics

The appropriate benchmark

The MEU suggests that there should be more emphasis on the concept of best practice to ensure that debt is secured in the most efficient way.[116] The MEU also takes the view that the term of the debt used as the benchmark should be in line with the length of the regulatory period.[117] It has no fixed view on the averaging period used for interest rates, other than it needing to be consistent and stable.[118]

The main concern of the ERA is ensuring that the proposed rule changes do not preclude its bond yield approach.[119] It considered that it does not.[120]

The QTC is concerned that broad regulator discretion could lead to debt benchmark characteristics that constrained the ability of service providers to adopt efficient debt financing and risk management strategies.[121] It suggests that the rules should require the regulator to demonstrate that their benchmark would not do this.[122]

Gas service providers stress the individually distinct nature of gas pipelines, which implies the need for more than a one-size-fits-all approach to any benchmark.[123] ATCO Gas, for example, argues that:

- the benchmarking process should not be used to ignore or "assume away" risks;
- the benchmarking process should not treat unlike businesses as though they are alike;
- in general, credit ratings should not be benchmarked; and
- the benchmarking process should not be used to ignore market realities.[124]

The joint submission from SA Power Networks, CitiPower and Powercor Australia, calls for the return on debt benchmark to be based on BBB+ 10-year Australian corporate bonds.[125] These NSPs argue that this has been the consistent definition in the past and does not require a change.[126] They reiterate their suggestion that, in

115 Ibid.

116 MEU, Draft Rule Determination submission, 4 October 2012, p. 12.

117 Id., pp. 17-18.

118 Id., p. 19.

119 ERA, Draft Rule Determination submission, 4 October 2012, p. 6.

120 Ibid.

121 QTC, Draft Rule Determination submission, 4 October 2012, pp. 13-14.

122 Ibid.

123 See, for example, APA Group, Draft Rule Determination submission, 4 October 2012, p. 4; ATCO Gas, Draft Rule Determination submission, 4 October 2012, pp. 3-5.

124 ATCO Gas, Draft Rule Determination submission, 4 October 2012, pp. 4-5.

125 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 15.

126 Ibid.

estimating the return, the regulator should have regard to a wide range of data, including BBB+ bonds with maturities less than 10 years and bonds with different credit ratings.[127]

The ENA and some service providers suggest that the draft rules did not sufficiently distinguish between benchmark specification and estimation.[128]

Regulatory allowance for return on debt estimate compared to observed debt servicing costs

The MEU submits that the regulator should be required to examine the actual historical practice of service providers to assist in identifying the most efficient structure for debt financing.[129]

The FIG is concerned that a number of provisions can be misinterpreted as suggesting that the cost of debt allowance should be adjusted to reflect the service provider's actual cost of debt. It considers that the rules should make it much clearer that the requirement is to set a benchmark cost of debt for an efficient firm.[130]

5.3.3 Return on debt for state-owned service providers

The EUAA disagree with the arguments made by the Commission for why return on debt for government-owned service providers should not be different from that for privately-owned service providers.[131] It argues that:

- the absence of competitive neutrality fees could not be expected to have any meaningful impact on allocative efficiency;[132]
- based on EURCC calculations, it was difficult to argue that taxpayers would be subsidising electricity users in the absence of competitive neutrality fees;[133]
- income taxes should be counted as part of the return on equity for government-owned service providers;[134]
- there is no meaningful level of competition between government-owned service providers and therefore the rationale for the application of the Competition Principles Agreement to these service providers is not valid;[135] and
- just as the AEMC proposes to guard against transfer pricing arrangements between related parties it should do the same for competitive neutrality fees as they are substantially the same thing.[136]

127 Ibid.

128 See, for example, Jemena, Draft Rule Determination submission, 4 October 2012, p. 26; ENA, Draft Rule Determination submission, 4 October 2012, p. 24.

129 MEU, Draft Rule Determination submission, 4 October 2012, p. 12.

130 The FIG, Draft Determination submission, 4 October 2012, p. 20.

131 EUAA, Draft Rule Determination submission, 4 October 2012, pp. 8-12.

132 Id., pp. 9-10.

133 Id., p. 10.

134 Id. pp. 10-11.

135 Id., p.11.

Submissions from some other consumer and energy user representative groups either endorse the arguments of the EUAA or make substantially similar arguments.[137]

5.4 Analysis

5.4.1 Options to use different methodologies

Proposal for return on debt methodology by the service provider

The Commission considers that the regulator must have the ability to make the final decision, subject only to any appeal process under the NEL and NGL, about the approach for estimating the return on debt, as part of its estimation of the rate of return consistent with the rate of return objective. It is very important that NSPs and other stakeholders have an opportunity to set out their views during the development of the regulator's rate of return guidelines, and within each determination process. However, the Commission does not consider it appropriate for the regulator's discretion as to which approach to adopt to be constrained by a particular proposal put forward by the NSP or through the existence of a default approach if the NSP does not agree with the regulator's preferred approach.

Factors to consider as part of assessing methodologies

The inclusion of the factors in the rules is intended to provide direction to the regulator as to what factors it should consider for determining the best approach to estimate the return on debt.

The factors reflect a number of key issues raised by SFG in its analysis of different methodologies for estimating the return on debt, and other stakeholders during the rule change process.[138] These issues can be summarised as follows:

- efficient benchmarking service providers may have different efficient debt management strategies;
- the effect on the cost of equity of different methodologies for estimating the return on debt;
- the effect on incentives for efficient capex during the regulatory period of the methodology used to estimate the return on debt; and
- consideration of whether transition arrangements are required if there is a change in the methodology used to estimate the return on debt.[139]

The first factor in the rule requires the regulator to have regard to the characteristics of a benchmark service provider and how this influences assumptions about its efficient debt management strategy. As highlighted by SFG in its report, debt management

136 Ibid.

137 UnitingCare Australia, Draft Rule Determination submission, October 2012, pp. 9-12; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, p. 1; MEU, Draft Rule Determination submission, 4 October 2012, pp. 13-17.

138 SFG Consulting, *Rule change proposals relating to the debt component of the regulated rate of return*, Report for the AEMC, 21 August 2012.

139 Id., p. 7.

practices tend to differ according to the size of the business, the asset base of the business, and the ownership structure of the business.[140]

The current prevailing market conditions "one-size-fits-all" approach required under the NER, and applied under the NGR, may lead to various mismatches between the regulatory estimate allowed by the regulator and the actual interest rate exposures of those service providers that employ debt management practices that are not closely aligned with the benchmark assumptions.

The second factor requires the regulator (and NSPs when making their proposals) to have regard to any potential benefit to consumers that could flow from reduced financing risks that may result from different return on debt methodologies. The intention is to require consideration of the potential impact on the return on equity that may result from a return on debt methodology that reduces the overall volatility of cash flows to equity holders. As modelling results provided by SFG show, in certain cases the cash flow volatility to equity holders can be reduced by better matching the debt component of the regulated return with borrowing costs.[141]

The third factor that requires the regulator to have regard to the incentive effects on capital expenditure recognises that any methodology for the return on debt allowance may affect service providers' incentives to make efficient investment decisions.

The purpose of the fourth factor is for the regulator to have regard to impacts of changes in the methodology for estimating the return on debt from one regulatory control period to another. Consideration should be given to the potential for consumers and service providers to face a significant and unexpected change in costs or prices that may have negative effects on confidence in the predictability of the regulatory arrangements.

It may be possible in many circumstances for the method to estimate the return on debt to take such concerns into account in the design of the method. Therefore, this criterion was intended to promote consideration of concerns raised by service providers with regard to transitions from one methodology to another. Its purpose is to allow consideration of transitional strategies so that any significant costs and practical difficulties in moving from one approach to another is taken into account.

The Commission has considered comments on how the factors were expressed in the draft rule and made some amendments in the final position rule to improve the drafting.

5.4.2 Specification of benchmark characteristics

The appropriate benchmark

The Commission retains the view that the NEO, NGO and RPP are more likely to be met by a non-prescriptive flexible framework that allows the regulator to more accurately match debt conditions in the market for funds.

140 Id., p. 21

141 Ibid.

It should remain open to the regulator and service providers to consider that different sectors and different kinds of service providers have different risk characteristics that lead to different characteristics for efficient debt financing. The Commission therefore agrees that a one-size-fits-all approach to setting a benchmark should not be considered a default position. However, the benefits of benchmarking for incentivising efficient financing practices must be retained.

In developing its rate of return guidelines, it is expected that the regulator will take into account the views of stakeholders on the appropriate benchmark and take account of the latest evidence relevant to the issue.

Regulatory allowance for return on debt estimate compared to observed debt servicing costs

On this issue, the Commission retains its conclusions from the draft rule determination. There is nothing in the new rules that will prevent regulators from adding the actual historical debt financing practices of service providers to the range of evidence that it considers in developing its methodologies. The return on debt allowance must still be estimated in a manner consistent with the overall rate of return objective. That is, it must be a benchmark cost of debt for an efficient firm. It should not be misinterpreted as suggesting that it must reflect a service provider's actual cost of debt.

5.4.3 Return on debt for state-owned service providers

After carefully considering the arguments made by the EURCC, and now the EUAA, the Commission still maintains its draft rule determination position. The principal objection to state-owned service providers' return on debt allowance being set with reference to the private sector borrowing cost stems from a widely held view that state-owned service providers borrow funds in debt capital markets at rates lower than comparable private-owned network service providers. The Commission emphasises that this view is not correct.

State-owned service providers do not access debt capital markets directly, but rather, their debt is managed by the respective state government’s treasury corporations through the issuance of government bonds, which is taxpayer backed bonds, directly in the market. It is the treasury corporations who have access to lower debt funding costs due to the government’s higher credit ratings compared to private sector businesses. Governments can generally borrow at lower rates than private firms due to governments’ ability to service the debt through taxation. The treasury corporations and state treasurers lend these funds to the state-owned service providers at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating. The stand-alone credit rating is the measure of the businesses’ credit worthiness independent of explicit or implicit financial support from the state governments.

This difference between the State’s borrowing costs and the costs faced by the state-owned service providers, commonly referred to as debt guarantee fees, represents consideration due to state taxpayers for accepting the business’ credit risk. This is not dissimilar to the fees charged by the Commonwealth Government for the guarantees it made available to Australian banks and state treasury corporations for their offshore term funding during the recent global financial crisis.

From the service providers' perspective, this mechanism ensures that they face borrowing costs that reflect the nature of their businesses, not the taxation powers of their government lenders. If state-owned service providers were to access debt capital markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings. Under such a scenario, it is likely that the interest rates that state-owned service providers would secure would not be materially different from the interest rate that privately-owned network service providers with the same credit ratings would attract.

This competitive neutrality/government debt guarantee fee is applied to the state-owned service providers by jurisdictional governments under the CPA. These businesses compete with their private sector counterparts and with the rest of the economy more generally for inputs such as capital and labour. If state-owned service providers were not required to pay any competitive neutrality/debt guarantee fees to reflect their stand-alone credit ratings, taxpayers in general would effectively be subsidising electricity consumers. Taxpayers would be taking the financial risk of guaranteeing debt repayment by these businesses without any compensation.

Suggesting that the interest rates that treasury corporations can secure reflects the actual debt financing costs of network service providers is not correct and ignores the fact that credit risk represents a real cost that should be accounted for.

If state-owned service providers did issue their own bonds, without a government guarantee they would face similar borrowing costs to the private sector service providers and the value represented by the guarantee fees would be transferred to bond holders. It is therefore difficult to justify how electricity consumers would be better off if competitive neutrality principles did not apply to state-owned service providers. Consequently, contrary to the views of the EURCC and the EUAA, it can be argued that the application of the CPA does not impede on the long term interest of electricity consumers. In the absence of competitive neutrality provisions, the debt costs of state-owned service providers would be substantially the same as the costs that would be expected to be incurred by privately-owned service providers. This is the principal reason the Commission does not support the EURCC's rule change request on this issue.

The Commission is of the view that the most appropriate benchmark to use in the regulatory framework for all service providers regardless of ownership in general is the efficient private sector service provider. If public sector benchmarks were to be used, it can be equally argued that such government ownership cost distinctions should be extended to labour input markets. The consequences of such a distinction could be that benchmarking the efficiency of state-owned service providers would not take account of the performance of privately-owned service providers.

Another important consideration for the Commission in deciding not to distinguish state-owned service providers' debt costs is the potential effect on businesses' future network investment decisions. The use of private sector benchmark debt costs assists in adding pressure on state-owned service providers to apply commercial discipline to their borrowing to fund any capex requirements. Faced with an artificially lower cost of capital, state-owned service providers may view network capex solutions as comparatively lower cost to non-network solutions (such as embedded generation), as compared to their private sector counter-parts.

The Commission responds below to some individual arguments proposed in the EUAA submission.

Allocative inefficiency

The Commission rejects the assertion that its arguments in the draft rule determination with respect to the absence of competitive neutrality fees are internally inconsistent.[142] It is clear from the wording of the draft determination cited by the EUAA that the Commission is presenting two possible outcomes that could arise in response to a removal of the fees, where the actual result is dependent on the response of the governments.[143] Specifically, absent any response from the government, the service provider could be expected to overspend. Whereas under the assumption that governments would alter their behaviour, stated as "arguably more likely", the service provider could then be expected to underspend.[144]

The Commission also disagrees with the EUAA's suggestion that it "erred because it has ignored the reality that service providers (that the governments own) are accountable to their government owners and so the cost of debt that they might see (after debt fees payable to their State Treasuries) is not relevant in their investment decision-making".[145] The EUAA conflates the role of shareholder management with the role of government. For privately-owned service providers the question is not as to what rate the shareholder can personally borrow at, but rather, as to what is the required rate of return given the risk of the businesses. There is no reason why tax-payers should not receive the same treatment. Just as it would be inappropriate for consumers to appropriate efficient returns made by private investors in risky assets, it is similarly inappropriate for consumers to appropriate efficient returns due to taxpayers.

Taxpayers subsidising users

In the Commission's view, the removal of competitive neutrality would mean taxpayers would be subsidising electricity consumers. If a service provider is provided debt at below market rate then, by definition, that constitutes a subsidy.

Taxes counted as return on equity

The Commission retains its position outlined in the draft rule determination that taxes are not a part of the return on equity. It further notes that the EUAA submission argues that distinguishing between tax receipts and return on equity is "to argue that administrative form should triumph over economic substance", at the same time as arguing that taxpayers should receive less return on risky assets than private investors.[146]

142 See, EUAA, Draft Rule Determination submission, 4 October 2012, p. 9.

143 Ibid.

144 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 86.

145 EUAA, Draft Rule Determination submission, 4 October 2012, p. 9.

146 Id., p. 11.

Competition or monopoly

The Commission does not agree that there is any concern with noting that, while service providers are generally monopolies, in some cases certain service providers may face some competition with other energy providers and may compete for inputs to their activities. The Commission notes that nothing turns on this as it does not reduce the validity of the argument that the removal of the competitive neutrality fees could lead to a misallocation of resources.

Regulatory authority

The Commission notes that the EUAA considers that there is a "double standard" at work predicated on its conflation of transfer pricing arrangements between related parties and the competitive neutrality fees charged by governments.[147] The Commission does not accept the comparison as valid. Further, even if were to accept the argument, this would not mean that the Commission would consider it appropriate or feasible to attempt to circumvent the CPA.

5.5 Guidance on final position rule

This section covers return on debt aspects of the new rate of return framework that the Commission has introduced, which was discussed in the previous chapter of this final position paper.

This section should be read in conjunction with the section in the previous chapter that discussed the final position rule for the overall rate of return framework, including how the final position rule is to be interpreted. It is particularly important to note that the final position rule places a requirement on the regulator to determine a rate of return that meets the overall allowed rate of return objective. This requirement can only be fully satisfied if the regulator considers its overall estimate against that objective. The Commission does not consider that the regulator could be satisfied it had met that overall objective if it made estimates about components or parameters that form part of the rate of return estimate in isolation and without considering the overall estimate against the overall objective. Therefore, those aspects of the final position rule that relate to the return on debt estimate should be seen as part of the analysis to inform the estimate of an overall rate of return.

As with the draft rule, the Commission has not mandated any particular approach to estimating the return on debt in the final position rule. Instead, the final position rule sets out at a very broad level the characteristics of three approaches to estimating the return on debt that could reasonably be contemplated by a regulator. The three options are designed to reflect an approach to return on debt based on:

- the prevailing cost of funds approach;
- an historical trailing average approach; or
- some combination of these two approaches.

The Commission intends the regulator (and the service provider in its regulatory proposal or access arrangement proposal) to have the discretion to propose an approach

147 Ibid.

that it considers best meets the overall allowed rate of return objective. This discretion for the regulator includes the detail of any approach, such as the period over which a prevailing cost of debt is observed, the length of any historical averaging period, and the form of measurement of the observed financing costs. In all cases the regulator's judgement is to be exercised in such a way as to be consistent with the overall allowed rate of return objective.

While the Commission considers that allowing the regulator to estimate the return on debt component of the rate of return using a broad range of methods represents an improvement to the current approach, it is a separate issue from that of benchmark specification and measurement. A historical trailing average approach still requires the regulator to define a benchmark and use appropriate data sources to measure it. Arguably, it is even more important that the benchmark is defined very clearly and can be measured, because it needs to be estimated periodically in the future. The measurability of the approach would be a factor that the regulator would have to consider as part of its assessment of different approaches.

The regulator will need to set out its approach(es) to estimating the return on debt in its rate of return guidelines. The Commission expects that the development of the guidelines will provide a forum for service providers, consumers and other stakeholders to propose different approaches to the estimation of return on debt, and for the regulator to discuss the merits of different approaches before setting out its proposed approach in the guidelines. The Commission intends that the regulator could adopt more than one approach to estimating the return on debt having regard to different risk characteristics of benchmark efficient service providers. Service providers will have an opportunity at the time of their determination or access arrangement to propose an alternative approach to that proposed by the regulator in the guidelines, but the service provider will need to explain why its proposed approach is better than the approach proposed by the regulator in the guidelines.

The final position rule includes a provision to allow an annual adjustment to the allowed revenue for the service provider in circumstances where the regulator decides to estimate the return on debt using an approach that requires the return on debt to be updated periodically during the regulatory period. The formula for calculating the updated return on debt must be specified in the regulatory determination or access arrangement and must be capable of applying automatically. Additional consequential amendments have been made in Chapters 6 and 6A of the NER to remove any impediments to allow the regulator to adjust its revenue/pricing determination during the regulatory period from the application of an annually updating return on debt estimate.

While the final position rule provides the regulator with the discretion as to the approach to adopt to estimate the return on debt, consistent with meeting the overall rate of return objective, the Commission considers that regulatory accountability and transparency is very important. Therefore, the final position rule includes factors that the regulator must have regard to when considering the approach to estimating the return on debt. It is not intended that these are the only factors the regulator can have regard to. In addition, the Commission has amended the factors slightly from that proposed in the draft rule to clarify its intentions.

6 Capex and opex allowances and factors

Summary

- The Commission has analysed evidence provided to it of the drivers of higher prices, which indicate that both the rate of return and expenditure allowances have been significant factors. However, it is not possible to discern if they have been inefficient, or if there is a problem with the NER.
- The approach to expenditure allowances was set by the AEMC in Chapter 6A in 2006. It includes that the NSP's forecast should be the starting point for the AER's analysis, but the AER is free to use a range of analytical techniques and should consider all material and submissions before it.
- Analysis confirms that the practices of the AER conform to good regulatory practice when compared with other regulators in Australia and overseas, and the Commission's view is that the NER reflects these practices.
- In general, the existing provisions of the NER provide the AER with appropriate discretion to set capex and opex allowances at an efficient level, assuming it has adequate information and uses appropriate analytical techniques.
- However, there are some areas for improvement to clarify the approach and remove ambiguities, specifically in relation to the AER's discretion and benchmarking.
- Benchmarking can play an important role in assessing the efficiency of a NSP’s capex and opex forecasts. Any use of benchmarking should take into account differences in the operating environments of the different NSPs. The AER should be required to undertake annual benchmarking of NSPs.
- It is appropriate that the approach for assessing expenditure forecasts be set out in guidelines. NSPs will be required to submit complying information with their regulatory proposal. Early engagement on these models with the NSP's is beneficial and should be included as part of the framework and approach paper.

Difference between draft rule and final position rule

- In the final position rule, the AER's discretion has been further clarified by the removal of general restrictions on the AER's discretion, consistent with the Commission's overall approach in this rule change.
- The obligation on a NSP to submit forecast expenditure methodologies as required by the AER will be adjusted. Instead the NSP may provide assessment information required by the AER separate to its regulatory proposal.

6.1 Introduction

The capex and opex allowances are a key component of a NSP's regulatory proposal. They comprise the forecast expenditure required to undertake investments and operate and maintain the network. The level, rather than the specific contents, of the approved expenditure allowances underpin the incentive properties of the regulatory regime in the NEM. That is, once a level of expenditure is set, it is locked in for a period of time, and it is up to the NSP to carry out its functions as it sees fit, subject to any service standards.

The NER provide matters for the AER to take into account in approving this important aspect of a NSP's total revenue requirement. The AER claims that the NER have constrained its ability to interrogate and amend expenditure proposals, resulting in capex and opex allowances which are higher than they should be.[148] While there are legitimate reasons for increases in network charges, it states that these constraints are also driving up network charges.[149] The AER proposed to be able to independently develop forecasts to use in scrutinising and amending NSPs' proposals.

The AER must also have regard to the capex and opex factors when considering proposals from NSPs for capex and opex. The AER has proposed a number of discrete changes to these factors, though some of these factors relate to other changes considered, including benchmarking and incentive schemes.

The remainder of this chapter is structured as follows:

- Section 6.2 summarises the Commission's position in the directions paper and draft rule determination;
- Section 6.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 6.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- Section 6.5 provides guidance on the final position rule.

6.2 Directions paper and draft rule determination

The draft determination proposed amendments in three areas:

- clarification of the rules regarding capex and opex allowances;
- annual benchmarking report and engagement on the expenditure forecasting model; and
- capex and opex factors.

A summary of the analysis and decision in relation to each these areas follows in the sections below.

148 AER, Rule change request, Part A, 29 September 2011, p. 8.

149 Id., p. 6.

6.2.1 Clarifying the discretion of the regulator

Background analysis

The analysis in the directions paper began by examining evidence for problems. The Commission did not come to a conclusion as to whether constraints in the NER were driving up network charges. It also referred to a report by Bruce Mountain which offered a way of assessing the efficiency of DNSPs' expenditure. The Commission stated that a similar type of analysis could have been utilised by stakeholders to illustrate whether capex and opex allowances were related to deficiencies in the NER. It also called for further evidence about the nature of the problem and its causes from stakeholders.

The ENA included a critique of Bruce Mountain's report in its submission to the directions paper stating that the analysis is too simplistic to be robust.[150] In the draft rule determination, the Commission accepted that it may be possible to undertake a more sophisticated analysis, however, no analysis has been provided which would challenge its conclusion that the average privately-owned DNSP is more efficient than the average state-owned DNSP.

Other submissions to the directions paper provided important context about rising network charges. Specifically, the ENA's and AER's submissions showed that capex, opex and rate of return are driving up network charges. However, the mere fact of increases, or even significant increases, in capex and opex allowances from one period to the next does not of itself demonstrate a deficiency in the NER. The AER analysis of specific constraints and the Brattle report commissioned by the AEMC comparing the original intent behind Chapter 6A with regulatory practice in other jurisdictions, were more useful resources.

The AER's analysis claimed that the capex and opex allowed in its previous decisions may have been higher than efficient on the basis that it was constrained in its ability to replace a NSP's forecast with a lower amount. It appears that each time the constraint was based on clause 6.12.3(f). Leaving aside any ambiguity associated with that clause, the AER appears to have taken a somewhat conservative approach to interpreting it. If the AER is correct that the capex allowance may have been higher than was efficient, it is not clear this was due to a deficiency in the NER.

The Brattle report considered whether the overall approach to expenditure allowances in Chapter 6A of the NER, and the AER's practices in applying Chapter 6A, conform to good regulatory practice. In addition to the AER, Brattle considered the regulatory approaches in Great Britain, New Zealand, New South Wales, Western Australia, Ontario and Rhode Island.[151]

Brattle did not identify any fundamental differences between the approach of the AER and the practices of regulators in the other jurisdictions. It noted that while the level of prescription in the rules differs among jurisdictions, the regulators operating under

---

150 ENA, Directions Paper submission, Attachment B, 16 April 2012.

151 The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 74. This paragraph also explains why each of the four overseas jurisdictions was chosen.

such rules do not undertake less analysis nor do they seem to be restricted in the choice of tools for the purposes of such analysis.[152] Rules may affect the weight put on the results of different analysis, but Brattle is not able to determine this conclusively.[153] On the basis of Brattle's conclusion, the Commission took the view that the approach to expenditure allowances in Chapter 6A, which generally reflects the AER's practices, remains fairly consistent with good practice as reflected in the practices of the other regulators examined by Brattle.

Brattle also made some observations about improvements to the NER. In some areas the approach could be clarified and the differences between Chapters 6 and 6A should only reflect fundamental differences in characteristics between transmission and distribution. For example, in respect of clause 6.12.3(f) of the NER, Brattle did not see how such a clause could constrain the AER, since a regulator will always use the NSP's proposal as a starting point, and will always explain its decision. However, the clause does not operate in a helpful way and could be clarified. In addition, Brattle did not see any reason to justify clause 6.12.3(f) in distribution given that there is no equivalent clause in transmission (Chapter 6A).

Brattle also highlighted the importance of good data for setting expenditure allowances at the right level. This includes annual data collection outside the determination process, and regular interaction with NSPs to ensure that the data collection process is operating effectively.[154]

On the basis of the above analysis, the Commission formed the following views:

- increases in the rate of return and expenditure allowances are both significant factors contributing to rises in network charges;
- some increases in expenditure allowances have been necessary;
- on the basis of the material considered, it is not possible to conclude that the NER have constrained the AER's ability to consider and substitute NSPs' expenditure forecasts and have caused inefficient increases in expenditure allowances; and
- while the Chapter 6A approach to capex and opex allowances remains generally consistent with good regulatory practice, it could be enhanced in some ways, and some changes for clarification reasons should be made so that Chapters 6 and 6A of the NER better reflect this approach.

As a result, the Commission determined to make a number of changes to clarify and remove ambiguity in the NER.

Proposed amendments

The Commission confirmed that the NER is drafted appropriately in many areas. With the exception of benchmarking, the capex and opex criteria remain valid. For example, the obligation to accept a reasonable proposal should reflect the AER's current practice. There is no reference to a reasonable range, which is appropriate.[155] The AER,

152 Id., paragraphs 13, 30 and 31.

153 Id., paragraph 33.

154 Id., paragraph 44.

155 Id, paragraph 42.

whenever it determines a substitute for a NSP's proposal, is not constrained by the capex and opex criteria from choosing the best substitute it can determine.

In terms of whether it is appropriate for the process to start with the NSP submitting a proposal to the AER, Brattle has shown that this is accepted practice in most of the jurisdictions it surveyed.[156] In jurisdictions where this did not occur, the regulator tended to be reviewing a large number of smaller businesses, such as in New Zealand. Of much more import is whether the AER has the necessary tools to scrutinise the NSP's proposal.

In the draft rule determination, the view was taken that the extent of the constraint imposed on the AER by clause 6.12.3(f) is unclear. This could be read as merely requiring the AER to treat the NSP's proposal as an input into its determination of a capex or opex allowance, or as preventing an AER substitute from moving away from a NSP's proposal beyond what is necessary to result in a reasonable allowance. NSPs stated that clause 6.12.3(f) is clear, but there have been few strong arguments about the benefits of this clause - and why it should be retained - in respect of capex and opex.[157] On the other hand, the AER has interpreted these provisions as imposing a much greater constraint on it.[158] Brattle also observed problems with this provision:

> "... it may be that neither 'adjusted only to the extent necessary' nor 'based on the NSP proposal' are helpful guides to the exercise of the regulator's judgment, in particular, if this were interpreted to rule out 'top down' adjustments.[159]"

Therefore, the Commission determined it should be made clear that clause 6.12.3(f) does not apply to capex and opex allowances. The guidance provided by this clause, such as requiring the AER to take into account the NSP's proposal, would be achieved by other provisions anyway, and this clause represents a difference between Chapters 6 and 6A for which there is no substantive benefit. The AER should not be limited to assessing a proposal on the basis of a "bottom up", engineering-based approach, and the AER should be free to determine a substitute amount on the basis of the information it has.

The AER proposed that the criterion relating to demand forecasts and cost inputs[160] was less important than the first two criteria and should be moved to the capex and opex factors. The view was taken in the draft determination that it would position demand forecasts and cost inputs as objectives rather than key elements of expenditure allowances that are relevant in a range of ways. The Commission therefore remained of the view that this criterion should remain where it is.

It was also determined that any impediments as to the use of benchmarking in the AER's analysis should be removed. The Commission views benchmarking as an important exercise in assessing the efficiency of a NSP and informing the determination

---

156 Id., paragraph 14.

157 ENA, Consultation Paper submission, Attachment C, 8 December 2011, p. 11; though note Ausgrid, Consultation Paper submission, 8 December 2011, p. 17.

158 AER, Directions Paper submission, 2 May 2012, p. 11 and Appendix 2 generally.

159 The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 38.

160 See for example, clause 6.5.7(c)(3).

of the appropriate capex or opex allowance. As a result, the Commission decided that the reference to "circumstances of the relevant NSP" should be removed from the capex and opex criteria. This was on the basis that there appears to be little doubt about how the AER should undertake a benchmarking exercise, including the circumstances that should be taken into account, and the reference to individual circumstances is likely to constrain the AER in an inappropriate way.

Other issues

The Commission shared the view expressed by Brattle that there could be greater consistency between Chapters 6 and 6A.[161] While recognising that these Chapters were developed by different organisations at different times, there should be no reason for any differences unless these are based on a fundamental difference between the characteristics of transmission and distribution networks or their owners. Differences in the NER not based on this may lead to ambiguity and a loss of clarity. In time, it may be possible for Chapters 6 and 6A to be merged into one. At present, changes are limited to those within the scope of the rule change process.

Certain issues raised by the AER, both in terms of expenditure allowances and the overall regulatory process, relate to the quality of the information available to the AER and the manner in which it is collected. For example, good quality information should make it easier for the AER to determine the reasonableness of capex or opex forecasts. There are notable differences in the provisions in Chapters 6 and 6A relating to information provision. Among other things, submission guidelines are part of Chapter 6A but may have been thought unnecessary in Chapter 6 with the advent of regulatory information orders and notices. The Commission therefore determined to adjust Chapter 6A to remove the rule requirement for the AER to prepare submission guidelines.

In the directions paper, the Commission noted the concern raised by the AER that the use of the word "maintain" in the capex and opex objectives may mean the AER is constrained in its ability to adjust expenditure allowances in the event that jurisdictional standards, for example, were to decrease or be relaxed.[162] It was decided in the draft determination that a change to these objectives would be outside the scope of this rule change. The Commission has since received a rule change request from the SCER which it will be considering in due course.[163]

6.2.2 Annual benchmarking reports and engagement on expenditure models

In the course of consulting on the rule change requests, other options for dealing with the original problems raised by the AER were identified. The Commission examined them and proposed in the draft rule determination to make changes in relation to:

161 Id., paragraphs 21, 35 and 41.

162 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 30.

163 The Commission recommended in relation to NSW reliability standards that should a change be made to licence conditions, a rule change request should be submitted to address this issue. See, AEMC, *Review of Distribution Reliability Outcomes and Standards, Final Report - NSW workstream*, 31 August 2012, section 6.4.2.

- annual benchmarking reports; and
- engagement on the expenditure model.

Each of these is discussed below.

Annual benchmarking reports

The Commission considered that changes needed to be made to improve the information available to consumers. For example, comparative network performance as well as adequate information about individual network performance would be of benefit to consumers. The view was taken that having access to this type of information would assist consumers both in informal interaction with NSPs as well as engaging in the formal regulatory process and merits reviews. The Commission considered that many of these aims would be achieved if the AER was required to undertake annual benchmarking of NSPs, with its results published in a report that could be accessible by consumers. This would set out the relative efficiencies of distribution and transmission NSPs, taking into account the exogenous factors that distinguish them.

It was also noted that these reports would assist the AER in assessing capex and opex forecasts as part of a regulatory determination. Having undertaken the benchmarking on an annual basis, it should be much quicker for the AER to benchmark as part of its determination. This requirement would not impact the AER's ability to utilise other analytical techniques.

In order to undertake an annual benchmarking exercise, the AER should use the best information available to it. Brattle underlined the importance of annual data collection outside of the regulatory determination process, and noted the effort other regulators have put into doing this.[164] It was noted that the AER does not undertake information gathering and benchmarking to the same extent as many other regulators but that may be limited by legal constraints on its information gathering powers.

Under section 28V of the NEL, the AER has the power to prepare network service provider performance reports. The annual benchmarking reports proposed in the draft rule are a subset of the reports the AER may publish under section 28V. However, there are limitations on using regulatory information instruments solely for the purposes of preparing network service provider performance reports: section 28F(3)(d) of the NEL. Changes to the NEL are outside the AEMC's power, however the SCER may wish to address this further. Changes to the NER may also provide the AER with greater powers in this respect. It was noted that the AEMC proposed to the SCER as part of its work on total factor productivity possible rule changes which would require NSPs to provide benchmarking information to the AER.[165]

Engagement on the expenditure model

The AER proposed in its submission on the directions paper a new solution for dealing with the problem raised in its rule change proposal of determining whether a NSP's capex or opex proposal is efficient.[166] This solution would require consultation on

---

164 The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 44.

165 The Commission has yet to receive a response from SCER in relation to this review.

166 AER, Consultation Paper submission, 12 December 2011, p. 12.

expenditure models as part of the framework and approach paper. Once a model is set in the framework and approach paper, the NSP would be required to justify its expenditure forecasts based on it, including any departures it has made from the model. This would enable more time for the AER to understand NSPs' forecast models, as well as be able to compare NSPs on a similar basis.

The Commission noted that the AER currently has difficulty in requiring a NSP to use a particular model to prepare its expenditure forecasts. Even if the AER has a preferred approach, the NSP need not use it. This means that the AER must spend time after the NSP's regulatory proposal is submitted to understand the NSP's model and engage with the NSP in respect of it.[167]

The Commission considered the best approach was to mandate the expenditure models to be used to prepare capex and opex forecasts. The view was taken that there were not any disadvantages in an approach which encouraged stakeholders to engage on the expenditure methodologies at an earlier stage. If the AER and stakeholders do not engage on the expenditure methodologies until after the regulatory proposal is submitted it will take up time during the evaluation stage. More critically, if the AER prefers a different methodology it may take the NSP some time to collect relevant information, putting pressure on the rest of the process. Instead, any expenditure methodology or methodologies preferred by the AER for a particular NSP should be included in the framework and approach paper. Importantly, for flexibility, it was decided that there should be no restriction on a NSP also including expenditure forecasts generated using other methodologies in its regulatory proposal.

6.2.3 Capex and opex factors

The AER proposed a number of discrete changes to the capex and opex factors. Below is a summary of the Commission's proposal in relation to each.

Process-related changes

The Commission maintained its position in the draft rule determination from the directions paper to move the process-related changes from the capex/opex factors to the "procedural" provisions further back in Chapters 6 and 6A.[168] These provisions have a different character from the other factors in that they deal with the materials presented to, or obtained by, the AER in the course of the regulatory process, as opposed to facts or data. As such, they sit better with the other procedural provisions, such as clause 6.11.1.

The ENA raised a concern at law that the AER's proposed shift from "have regard to" wording to "consider" wording in respect of two of these factors will affect the overall decision-making process.[169] To accommodate this, the draft rule adopted the "have regard to" wording for all three factors.

167 AER, Directions Paper submission, 2 May 2012, p. 12.

168 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 33.

169 ENA, Directions Paper submission, Attachment F, 16 April 2012, p. 68.

The Commission further considered the views it presented in the directions paper regarding the requirement on the AER to consider analysis it has published.[170] It acknowledged the challenges in using merits review to test analysis published with a final regulatory determination, and notes that under section 16(1)(b) of the NEL the AER is required to inform NSPs of material issues under consideration, as raised in the ENA's submission.[171] However, the Commission maintained the position that because of the fixed time the AER has to reach a final regulatory determination there could be times when it is too difficult for the AER to consult on analysis prior to it. To balance the time constraints against the need for scrutiny of new material, the draft rule required the AER to use its best endeavours to publish analysis on which it proposes to rely, or which it proposes to refer to, prior to the making of the final regulatory determination. Further, in the event of any inconsistency between the NER and NEL, the NEL has priority over related provisions of the NER.

Non process-related changes

In the draft rule determination, the Commission maintained its view from the directions paper that the capex and opex factors should remain mandatory considerations. In respect of whether these factors are exhaustive, the Commission also maintained its position from the directions paper that the AER is not at present limited to the factors set out in the NER. At the same time, however, different clauses in the NER take an inconsistent approach to whether additional drafting was required to confirm that factors are exhaustive, and this could lead to ambiguity. To clarify this, an additional factor was added to the capex and opex factors allowing the AER to consider other factors. Since a NSP should be given the opportunity to address factors against which its forecast will be assessed, the draft rule included a requirement that the AER notify the NSP in advance of any such additional factor or factors. This reflects the AER's obligations in section 16(1)(b)(i) of the NEL.

Various other changes to the capex and opex factors were also proposed. One factor relates to the service target performance incentive scheme (STPIS) (see for example clause 6.5.6(e)(8)). The original intent behind this factor is that expenditure allowances with respect to labour costs should be sufficient to allow the NSP to respond to the incentives as part of the STPIS. The AER has suggested this factor could be broadened.[172] The Commission agreed with this and removed the reference to labour costs and broadened the scope of the incentive schemes covered. In addition, consequential amendments were proposed to the capex and opex factors in Chapter 6 to recognise the addition of the contingent projects regime.

It was also proposed that the factor relating to benchmarking[173] be expanded to refer to the annual benchmarking reports.

---

170 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 32.

171 ENA, Directions Paper submission, 16 April 2012, p. 41; and ENA, Directions Paper submission, Attachment F, 16 April 2012, p. 69.

172 AER, Rule change request, Part B, 29 September 2011, p. 34.

173 See for example clause 6.5.7(e)(4).

Finally, a factor was added that requires the AER to have regard to the extent to which NSPs have considered what consumers seek. NSPs should be engaging with consumers in preparing their regulatory proposals and should factor in the needs and concerns of consumers in determining, for example, their capex programs. What consumers want and are prepared to pay for, whether in terms of reliability or some other element, will assist in showing what is efficient. The more confident the AER can be that consumers' concerns have been taken into account, the more likely the AER could be satisfied that a proposal reflects efficient costs. A similar approach is taken in Great Britain by Ofwat in respect of water regulation.[174]

6.3 Submissions

Submissions from consumer representative and large user groups are supportive of the changes proposed in the draft determination.[175] The AER is also strongly supportive of the changes. It states that the draft rules are a clear improvement by allowing it greater scope to reject excessive cost forecasts. However, it has raised concern over the remaining restrictions in clause 6.12.3(f) as well equivalent clauses in Chapter 6A (discussed below).[176] Independent Pricing and Regulatory Tribunal (IPART), the Victorian Department of Primary Industries (Victorian DPI) and retailers are also supportive of the changes.[177]

UE and MG support the changes to clarify the NER as well as benchmarking. However, like many of the NSPs, they do not support the changes in relation to an expenditure forecast methodology, which is also reflected in the ENA's submission.[178] The ENA also has concerns in relation to benchmarking and the amendments to clause 6.12.3(f).[179] Submissions on all three of these specific issues are discussed below.

6.3.1 Clarifying the discretion of the regulator

The AER supports the reasons for the amendments to clause 6.12.3(f) but states that it still restricts the AER from making overall decisions. It proposes for the clause to be deleted, as there have been no strong arguments to support the retention of the remaining restrictions. It states that without the clause it is still required under

174 See for example Ofwat, *Involving customers in price setting - Ofwat's customer engagement policy statement*, April 2011, p. 21.

175 MEU, Draft Rule Determination submission, 4 October 2012, p. 20; EUAA, Draft Rule Determination submission, 3 October 2012, p. 15; Ethnic Communities' Council, Draft Rule Determination submission, 4 October 2012, p. 2; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 2; Alternative Technology Association, Draft Rule Determination, 4 October 2012, p. 8.; UnitingCare, Draft Rule Determination submission, 16 October 2012, p.15.

176 AER, Draft Rule Determination submission, 5 October 2012, p. 10; AER, Draft Rule Determination supplementary submission, 25 October 2012, pp. 8-9.

177 Victorian DPI, Draft Rule Determination submission, 2 November 2012, pp. 1-2; IPART, Draft Rule Determination submission, 2 October 2012, pp. 5-6; Origin Energy, Draft Rule Determination, 4 October 2012, p. 1; EnergyAustralia, Draft Rule Determination submission, 15 October 2012, p. 2.

178 UE and MG, Draft Rule Determination submission, 4 October 2012, pp. 11-14; ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-33.

179 ENA, Draft Rule Determination submission, 4 October 2012, pp19-21; 33-36.

administrative law and other clauses in the NER to take into account a NSP's proposal and all relevant information.[180]

SA Power Networks, CitiPower and Powercor submit that the clause should remain unchanged. It states that the clause is consistent with the recognition that the NSP's proposal is the most detailed and relevant evidence.[181] The ENA disagrees with the carve out of rate of return from this clause.[182] This has been discussed in section 4.4 above. The ESAA has also raised that by providing more discretion to the AER increases the risk that overall revenue is inadequate and the AER needs to carefully consider how it minimises this risk.[183]

6.3.2 Benchmarking

UE and MG disagree with the draft amendment to remove the "individual circumstances" phrase. They state that an assessment of prudent and efficient expenditure requires consideration of the particular circumstances and that without it there is a signal that a NSP's circumstances are not relevant.[184] Likewise, SA Power Networks, CitiPower and Powercor disagree with the removal of the phrase, since the AER has been shown not to consider individual circumstances in cases before the Tribunal.[185] The ENA also disagrees with its removal stating that the phrase does not constrain benchmarking and that recognition of individual circumstances are a fundamental element for an assessment of forecasts.[186] Grid Australia also disagrees with the removal of the phrase.[187]

Grid Australia is concerned about the role of benchmarking and refers to the findings of the Total Factor Productivity Review (a form of benchmark regulation) which found that it is not appropriate to be applied to transmission.[188] Ergon Energy states that consideration should also be given to the costs of collection of additional information and that differences in networks mean it may not be possible to take into account all relevant factors. In that case, the AER should have discretion not to publish an annual report. If required to publish one, it should not be directed to have regard to the last one as there will be a lag with the data and as a result publication of such a report is likely to mislead less informed market participants.[189] SA Power Networks, CitiPower and

180 AER, Draft Rule Determination submission, 5 October 2012, pp. 10-13.

181 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p.19.

182 ENA, Draft Rule Determination submission, 4 October 2012, pp. 19-21.

183 ESAA, Draft Rule Determination submission, 23 October 2012, p. 3.

184 UE and MG, Draft Rule Determination submission, 4 October 2012, pp. 13-14.

185 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 18-19.

186 ENA, Draft Rule Determination submission, 4 October 2012, pp. 33-36.

187 Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 11

188 Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 11.

189 Ergon Energy, Draft Rule Determination submission, 7 October 2012, pp. 6-7.

Powercor have no objection to the preparation of benchmarking reports but consider further guidance useful, such as the relevant factors to consider.[190]

The AER is supportive of the changes to benchmarking, as is Origin Energy.[191]

6.3.3 Expenditure forecast methodology

SP AusNet states that the expenditure forecast methodology conflicts with the NSP's responsibility for preparing and submitting expenditure forecasts in its regulatory proposal. Furthermore, it states that an additional methodological approach in addition to the one preferred by the NSP will result in duplication.[192] Jemena also does not support a standard expenditure forecast methodology. It states that it is inconsistent with current sign-off requirements and will duplicate work where a NSP still needs to provide its own best forecast and the AER must evaluate both.[193] The ENA provides similar reasons in its submission, it states that it would be more appropriate to require NSPs to provide an informal briefing to the AER on their approaches at the framework and approach stage. The ENA provides alternative rule amendments consistent with its recommendations.[194]

On the contrary, SA Power Networks, CitiPower and Powercor support the proposal to establish standard forecasting approaches. They state that it should encourage forecasting issues to be discussed upfront at the framework and approach stage. However, they state that the intention that NSPs are free to submit their own forecast based on methodologies other than those in the framework and approach paper is not sufficiently clear in the drafting and should be clarified.[195]

The AER is strongly supportive of the proposal stating that it will support benchmarking and its ability to determine an efficient estimate of forecast costs.[196]

6.3.4 Capex and opex factors

SA Power Networks, CitiPower and Powercor states that "any other factor" should be identified at the framework and approach stage. Such an approach would ensure appropriate consultation and allow parties other than the NSP to be aware of what they may include.[197] In contrast, the AER has submitted that it should be able to consider any other factor prior to the submission of a revised proposal since other relevant factors may arise during the regulatory process after the submission of a regulatory

190 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 17-19.

191 AER, Draft Rule Determination submission, 5 October 2012, pp. 12-13; Origin Energy, Draft Rule Determination submission, 4 October 2012, p.1.

192 SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 3-4.

193 Jemena, Draft Rule Determination submission, 4 October 2012, pp. 10-14.

194 ENA, Draft Rule Determination submission, 4 October 2012, pp. 29 -33.

195 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 17-18.

196 AER, Draft Rule Determination submission, 5 October 2012, pp. 11-12.

197 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 19.

proposal.[198] Energex has also suggested that the factor to refer to the annual benchmarking report refer to benchmarking material more generally, as there may be other info that may be equally relevant.[199] The Energy Supply Association of Australia (ESAA) submitted that in relation to the factor on consumer consultation, it will be important to understand how the AER will evaluate supporting evidence. It states that consumer consultation is costly and cost recovery for such activities must also be taken into account.[200]

6.4 Analysis

This section responds to issues raised in submissions to the draft rule determination and sets out the Commission's reasoning for its final position.

6.4.1 Clarifying the discretion of the regulator

In the draft determination the Commission amended clause 6.12.3(f) so it was made clear that the restrictions on the AER's discretion to make substitute decisions did not apply in respect of capex or opex allowances (or, as discussed in chapter 4, rate of return framework). This was determined on the basis that there is no equivalent clause in Chapter 6A and that the AER's interpretation of the clause was imposing a greater constraint on it than intended. Further, the Brattle report identified the wording of the clause as unhelpful, in particular if it were to be interpreted to rule out "top down" adjustments.[201]

Although the AER proposed the removal of the entire clause (as well as the equivalent clause in Chapter 6A), the Commission took the view that the ambiguity which was highlighted by the AER was primarily in relation to capex and opex allowances (chapter 4 includes a discussion regarding the rate of return issue with regard to this clause). The view was taken that an amendment similar to that which is contained in Chapter 6A, which excludes capex and opex from the same limitation, would clarify the intention of the clause and address the AER's concerns.

However, the AER's submission to the draft determination states that, despite the carve out of capex and opex allowances, restrictions on the remaining provisions may prevent it from making overall decisions in expenditure allowances. As a result, the AER maintains that the clauses should be deleted such that it can make overall decisions that are aimed at satisfying the NEO.[202] It gives the following reasons:

1. Other decisions affect the capex and opex allowances, such as depreciation, cost inputs and demand forecasts which are subject to the restrictions. As components of the capex and opex allowances, to the extent they remain subject to restrictions, the AER remains restricted in determining the total values. At a minimum, the

198 AER, Draft Rule Determination supplementary submission, 25 October 2012, p. 6.

199 Energex, Draft Rule Determination submission, 4 October 2012, p. 2.

200 ESAA, Draft Rule Determination submission, 23 October 2012, p. 3.

201 The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 38.

202 AER, Draft Rule Determination submission, 5 October 2012, p. 10; AER, Draft Rule Determination supplementary submission, 25 October 2012, pp. 8-9.

AER states it creates confusion and uncertainty around how these provisions may operate within a total determination decision.

2. Without capex, opex and rate of return allowances being subject to the clause it is unclear why the remaining restrictions are appropriate. The AER considers that no strong arguments have been put forward to support the retention of the remaining restrictions.

3. There is no clear rationale for the operation of the clauses once it is accepted that capex, opex and rate of return decisions should not be subject to these restrictions.[203]

The Commission accepts that there are many interrelationships between various inputs and values. For example, clause 6.12.1(10) which relates to any other appropriate amounts, values or inputs could be relevant to components of overall capex decisions such as unit rates or escalation factors. It would be difficult to specify those relationships within the framework of the NER with sufficient clarity to facilitate the intention of the carve out. As a result, relaxing the constraint on the overall capex decision would be inconsistent with leaving the constraints on potential inputs to that decision. Further, the constraint would still remain on overall revenue (clause 6.12.1(2)) which may potentially constrain the extent that capex, as an input to that decision, could be amended.

In this rule change process the Commission's overall approach is to give more discretion with appropriate accountability to the AER to make appropriate regulatory decisions. In many areas there are objectives or factors for the AER to consider. Indeed, in relation to capex and opex allowances there are considerations for the AER's decision making in the criteria, objectives and factors. The Commission is of the view that seeking to limit the AER's discretion in a general way is not consistent with this. The NSP's proposal is a significant input, but there should be other factors and information for the AER to consider.

Furthermore, the Commission shares the view that there is insufficient evidence to support the restriction on the remaining provisions. As the AER has pointed out:

> "To the extent these clauses oblige the AER to take into account an NSP's proposal, this is already achieved by clauses 6.10(1)(b)(1), 6.11(1)(b)(1), 6A.12.1(a1)(1) and clause 6A.13.1(a1)(1). Further, administrative law requires the AER to have due regard to all relevant information before it when making decisions. The information in an NSP's proposal is *clearly* relevant information.[204] [emphasis added]"

As discussed further below, all public decision makers must base their decisions on sound reasoning and relevant information. Therefore, the final position rule does not include clause 6.12.3(f) and clauses 6A.13.2(a). The way that the AER exercises its judgment in respect of the proposal and the rest of the evidence may achieve the same result as clause 6.12.3(f), but the NER will no longer prescribe it.

203 AER, Draft Rule Determination submission, 5 October 2012, pp. 10-11.

204 Id., p. 11.

6.4.2 Benchmarking

The Commission is of the view that the removal of the "individual circumstances" clause does not enable the AER to disregard the circumstances of a NSP in making a decision on capex and opex allowances. Benchmarking is but one tool the AER can utilise to assess NSPs' proposals. It is not a substitute for the role of the NSP's proposal. Should the phrase remain, it appears that the AER's interpretation of it may restrict it from utilising appropriate benchmarking approaches to inform its decision making.

The Commission considers that the removal of the "individual circumstances" phrase will clarify the ability of the AER to undertake benchmarking. It assists the AER to determine if a NSP's proposal reflects the prudent and efficient costs of meeting the objectives. That necessarily requires a consideration of the NSP's circumstances as detailed in its regulatory proposal.

Under the first expenditure criterion the AER is required to accept the forecast if it reasonably reflects the efficient costs of achieving the opex objectives. These include references to the costs to meet demand, comply with applicable obligations, maintain quality, reliability and security of supply of services and of the system. These necessarily require an assessment of the individual circumstances of the business in meeting these objectives. So to the extent that different businesses have higher standards, different topographies or climates, for example, these provisions lead the AER to consider a NSP's individual circumstances in making a decision on its efficient costs.

The ENA states that the important function of the phrase is highlighted by the Tribunal case regarding Powercor's vegetation management.[205] SA Power Networks, CitiPower and Powercor also reference this case by highlighting that the AER is not immune to errors and that the phrase reminds it to have regard to those circumstances which are relevant to any benchmarking exercise. However, the Commission notes that the judgement does not explicitly state which clause, or phrase within a clause, it has based its decision to remit the decision back to the AER. Specifically, the Tribunal stated that the AER's consultant failed to pay proper account of the differences between Powercor's network and work program and those of the other DNSPs.[206]

Annual benchmarking reports

The Commission notes that most stakeholders are supportive of the annual benchmarking reports. It does not accept the reasons provided by Ergon that the AER should have discretion in respect of whether or not to produce/publish such reports.[207]

The intention of a benchmarking assessment is not to normalise for every possible difference in networks. Rather, benchmarking provides a high level overview taking into account certain exogenous factors. It is then used as a comparative tool to inform assessments about the relative overall efficiency of proposed expenditure. This view is consistent with that put forward in a submission by Grid Australia to the consultation

205 ENA, Draft Rule Determination submission, 4 October 2012, p. 35.

206 *Application by United Energy Distribution Pty Limited* [2012] ACompT 1, [666]

207 Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

paper.[208] Further, it is intended that the annual benchmarking report will be a useful tool for stakeholders, such as consumers, to engage in the regulatory process and have better information about relative performance of their NSPs. An expectation of annual publication adds to that value. The Commission therefore determines that the annual benchmarking report remain an annual obligation.

The Victorian DPI also raised the issue that the ability to carry out meaningful benchmarking relies on gathering data from the NSPs. Specifically it states that:

> "Without systematic and comparable data from all NSPs, the AER will not be able to draw inferences about an individual NSP's performance against a benchmark with sufficient rigor to support is use as an analytical tool informing decisions in pricing reviews. The mere fact of publication of a benchmarking report may not materially improve the AER's pricing determinations.[209]"

The Victorian DPI noted that the SCER has not yet responded to the AEMC's recommendations for improved data collection in the TFP Review. As a result, the Victorian DPI has suggested that the AEMC make a substantially similar rule to support the AER's role in assessing efficient network expenditure.[210] The Commission is sympathetic to the Victorian DPI's concerns, however, it is not appropriate to include such provisions at this stage, as they would not have been subject to consultation. The Commission stresses the importance of quality data collection (including on an annual basis) by the AER to support the changes in this final position rule. It notes that this is a point of difference between the AER's practice and that of best practice highlighted by Brattle.[211] As noted in the draft rule determination, the SCER may wish to consider changes to the NEL to facilitate annual data collection by the AER for the purposes of benchmarking reports.

6.4.3 Engagement on expenditure models

In the draft rule determination the Commission introduced a requirement for the AER to develop a standard expenditure forecasting methodology. The AER would determine at the framework and approach stage how the methodology should be applied by a specific NSP which it would be required to include in their regulatory proposals, in addition to any differing approach they may take. This was determined on the basis that it would facilitate engagement on the expenditure forecasting methodologies adopted by NSPs as well as enable the AER to compare information from NSPs on a similar basis. The AER is strongly supportive of the draft rule whereas NSPs are strongly opposed to the imposition of forecasting methodologies to address

208 Grid Australia, Consultation paper submission, 8 December 2011, p. 9

209 Victorian DPI, Draft Rule Determination submission, 2 November 2012, pp. 1-2.

210 Id, p. 2

211 The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 28.

the problems raised.[212] However, there is agreement that early engagement on expenditure models is desirable.[213] Each of these issues is discussed in turn below.

Standard expenditure forecasting model

The ENA raises a number of concerns with the Commission's approach to impose a standard expenditure model. Primarily, these appear to centre around the NSP's role in managing its network and that linkage with the expenditure forecasts. Because of the NSP's role in daily planning and operation of the business, it should be able to produce the best information. Moreover, that the role and responsibility of developing the approach to forecasting should be consistent with the accountability for expenditure outcomes. The ENA further states that this is consistent with internal sign-off that the forecast expenditure reflects the expenditure which is truly required by the NSP.[214]

The Commission accepts that responsibility for developing a NSP's proposal should remain with the NSP. This includes the development of an expenditure forecast in a manner that the NSP views as appropriate. It is the AER's role to assess the NSP's proposal using any tools it views as appropriate. Nevertheless, it remains important for the AER to receive information which enables it to effectively assess a NSP's proposal and be aware of how the NSP plans to forecast its expenditure. The ENA has proposed that the AER develop a guideline for its assessment techniques.[215] The Commission sees merit in this approach.

As a result, the final position rule requires the AER to develop guidelines on its assessment techniques. At the framework and approach stage the AER will determine how the guidelines apply to the particular NSP. The NSP is then required to submit information in compliance with the application of the guidelines as determined in the framework and approach paper *with* its proposal. This information would not form part of the NSP's formal proposal and therefore should not need to be subject to the same sign-off requirements as the proposal. There will no longer be a requirement to include in the proposal itself a forecast determined in a manner set by the AER. However, the final position rule does not preclude the NSP from including the information in its proposal if it so chooses.

The assessment techniques included in the AER's guidelines are not an exhaustive list of all the techniques the AER may apply. In particular, after reviewing the NSP's regulatory proposal the AER may decide it wants to use additional assessment techniques it has not previously expected to use.

The final position rule should address the NSPs' concerns regarding internal sign-off as the information required is not part of the NSP's proposal. Further, the Commission notes that the rules do not require an overall executive level sign-off on the regulatory

212 AER, Draft Determination submission, 5 October 2012, p.12.; ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-36; Jemena, Draft Rule Determination submission, 4 October 2012, pp. 10-14.

213 ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-36; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 19

214 ENA, Draft Rule Determination submission, 4 October 2012, pp. 30-31.

215 Id, p. 33.

proposal. However, the rules do allow the AER to obtain the information it requires to assess the NSP's proposal.

Engagement on NSPs' expenditure forecasting models

The Commission remains of the view that early engagement on expenditure models is desirable. This view is shared by NSPs in submissions.[216] The ENA has proposed an alternative to the Commission's approach in the draft rule determination - that NSPs advise the AER of their forecasting methodologies at the framework and approach stage.[217]

The Commission agrees that engagement on expenditure models can be facilitated in ways other than that included in the draft rule. Indeed, a rule is not strictly required to enable engagement, as SP AusNet noted:

> "in a cooperative approach to the conduct of the price review it is incumbent on the service provider and AER to meet early in the review process, and periodically, to discuss relevant matters, including the form of outputs from the service providers expenditure forecasting models.[218]"

The Commission is reluctant to formalise a requirement for engagement. However, expenditure models are an integral component in the assessment process such that mandating a minimum requirement for engagement provides a starting point in this important area. Therefore, the Commission's final position is to adopt the ENA's proposal that NSPs will be required to advise the AER of its approach to expenditure forecasting. That is, the NSP and the AER will engage on the information requirements for the AER's assessment models, as well as how the NSP approaches expenditure forecasting.

The Commission views the early engagement with NSPs, as well as broader industry engagement in developing the guidelines, as beneficial. It will potentially save time and effort for both parties once the regulatory process has commenced.

6.4.4 Capex and opex factors

SA Power Networks, CitiPower and Powercor proposed that the inclusion of "any other factor" be identified in the framework and approach paper.[219] The Commission agrees that raising any other factor at the framework and approach stage is a reasonable suggestion as well being a convenient forum to discuss any additions. However, it notes that there are currently no limits on what the AER includes in the framework and approach paper so no rule is required for such an outcome to occur. It would not be appropriate to mandate such an approach. It is noted that clause 16(1)(b) of the NEL protects a NSP from any material change in the AER's analysis without notification.

---

216 ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-36; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 19; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 3-4.

217 ENA, Draft Rule Determination submission, 4 October 2012, p. 33.

218 SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 4.

219 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2010, p. 19.

The AER submitted that it should be able to raise any other factor prior to the submission of a revised regulatory proposal. This would allow it to consider other relevant factors which may arise after the submission of a NSP's regulatory proposal. It states that there appears to be no justification to exclude any relevant factors so long as the NSP is informed of them up to the cross submissions stage.[220] The Commission sees the potential for relevant factors to arise following the submission of the proposal. However, it does not see that the AER should be able to raise a new factor up to the cross submissions stage. This stage is discretionary and designed to address matters raised in submissions. Accordingly, the clause will be amended to reflect that the AER can raise a new factor up to the submission of a revised regulatory proposal. The Commission considers that the existing capex and opex factors are sufficiently broad that it should be rare that the AER would need to consider additional factors.

Energex has proposed that the factor which requires the AER to have regard to the latest annual benchmarking report be broadened to refer to benchmarking material more generally.[221] The Commission agrees that there may be other benchmarking information available to the AER, some of which may be more relevant than the annual benchmarking report. However, the AER's consideration of such material is not precluded from the rule as in addition to the most recent annual benchmarking report it also states the benchmarking expenditure that would be incurred by an efficient NSP. The consideration of a benchmark NSP enables consideration of broader benchmarking information. As such, the Commission's final position is not to make any changes to this factor.

6.5 Guidance on final position rule

6.5.1 Clarifying the discretion of the regulator

The NSP's proposal is necessarily the procedural starting point for the AER to determine a capex or opex allowance.[222] The NSP has the most experience in how a network should be run, as well as holding all of the data on past performance of its network, and is therefore in the best position to make judgments about what expenditure will be required in the future. Indeed, the NSP's proposal will in most cases be the most significant input into the AER's decision. Importantly, though, it should be only one of a number of inputs. Other stakeholders may also be able to provide relevant information, as will any consultants engaged by the AER. In addition, the AER can conduct its own analysis, including using objective evidence drawn from history, and the performance and experience of comparable NSPs. The techniques the AER may use to conduct this analysis are not limited, and in particular are not confined to the approach taken by the NSP in its proposal.

While the AER must form a view as to whether a NSP's proposal is reasonable, this is not a separate exercise from determining an appropriate substitute in the event the AER decides the proposal is not reasonable. For example, benchmarking the NSP against

220 AER, Draft Rule Determination supplementary submission, 25 October 2012, p. 6.

221 Energex, Draft Rule Determination submission, 4 October 2012, p. 2.

222 See also comments made in The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraphs 14 and 71.

others will provide an indication of both whether the proposal is reasonable and what a substitute should be. Both the consideration of "reasonable" and the determination of the substitute must be in respect of the total for capex and opex.

The criteria for determining capex and opex contain a requirement that the AER must accept a proposal that is reasonable. It seems almost to go without saying that the AER must accept such a proposal. Why the AER would ever need to reject a proposal that it has determined is reasonable is unclear. The idea of reasonableness was used at times in consultation in 2006 to refer to a "reasonable range".[223] This is a concept that can be misleading in the context of the exercise the AER must conduct in determining a capex or opex allowance. The AER has confirmed that it does not generally approach capex and opex allowances by determining a maximum and minimum possible allowance, and indeed the lack of precision inherent in this exercise would mean this has little benefit.[224] The use of the term "reasonable" merely reflects this lack of precision. Thus, the AER could be expected to approach the assessment of a NSP's expenditure (capex or opex) forecast by determining its own forecast of expenditure based on the material before it. Presumably this will never match exactly the amount proposed by the NSP. However there will be a certain margin of difference between the AER's forecast and that of the NSP within which the AER could say that the NSP's forecast is reasonable. What the margin is in a particular case, and therefore what the AER will accept as reasonable, is a matter for the AER exercising its regulatory judgment.

The Commission remains of the view that the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own.[225] The obligation to accept a reasonable proposal, reflects the obligation that all public decision-makers have to base their decisions on sound reasoning and all relevant information required to be taken into account. Some submissions have referred to the concept of an evidentiary burden, or onus of proof, as some submissions have termed it, that the AER has.[226] To the extent the AER places probative value on the NSP's proposal, which is likely given the NSP's knowledge of its own network, then the AER should justify its conclusions by reference to it, in the same way it should regarding any other submission of probative value. In circumstances where the NSP is required to provide information in support of its proposal, and the AER is required to explain its decision, an evidentiary burden does not appear to reside with one party more than another.

When the AER assesses an expenditure forecast it has certain criteria to assess the forecast against, and certain factors it must bear in mind. These criteria broadly reflect the NEO, and include the efficient costs of a prudent operator and a realistic expectation of demand. The AER assesses the total of the capex or opex forecast and is not required to consider individual projects. The Commission considers that the rules give the AER sufficient freedom to set capex and opex allowances that are efficient, assuming it applies appropriate analytical techniques and has access to an appropriate level of information.

223 AEMC, Economic Regulation of Transmission Services, Rule Determination, 16 November 2006, p. 52.

224 AER, Response to AEMC questions, 2 February 2012, p. 10.

225 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 53.

226 EUAA, Directions Paper submission, 16 April 2012, p. 17.

6.5.2 Benchmarking

The final position rule gives the AER discretion as to how and when it undertakes benchmarking in its decision-making. However, when undertaking a benchmarking exercise, circumstances exogenous to a NSP should generally be taken into account, and endogenous circumstances should generally not be considered. In respect of each NSP, the AER must exercise its judgement as to the circumstances which should or should not be included. However exogenous factors to be taken into account are likely to include:

- geographic factors: topography and climate;
- customer factors: density of the customer base (urban v rural), load profile, mix of customers between industrial and domestic;
- network factors: age, mix of underground and overhead lines, though this will depend on the extent to which this is at the election of the NSP; and
- jurisdictional factors: reliability and service standards.

If there are some exogenous factors that the AER has difficulty taking adequate account of when undertaking benchmarking, then the use to which it puts the results and the weight it attaches the results can reflect the confidence it has in the robustness of its analysis.

Endogenous factors not to be taken into account may include:

- the nature of ownership of the NSP;
- quality of management; and
- financial decisions.

It is also expected that similar considerations be made when undertaking the annual benchmarking report.

6.5.3 Engagement on expenditure models

The final position rule requires the AER to develop expenditure forecast assessment guidelines. The guidelines will set out the types of assessments the AER will undertake in approving expenditure allowances and the information requirements from NSPs to facilitate those assessments. At the framework and approach stage the AER will document any deviations as well as specific information requirements as they apply to the NSP under review. The NSP will also be required to advise the AER of its approach to expenditure forecasting at least 24 months before the expiry of its existing determination. The timing is intended to coincide with the framework and approach stage and so the NSP could include a description of its intended approach in its submission to avoid a separate step and provide context for the AER's assessment approach.

When the NSP submits its proposal it is required to submit an accompanying document complying with the requirements of the expenditure forecast assessment guidelines, or as otherwise specified in the framework and approach paper. This document is not, nor does it form part of, a NSP's expenditure forecast as included in its proposal unless the NSP chooses to include complying information as part of its proposal. Therefore, the director certification requirements under clause S6.1.1(5) would not apply as it does not form part of the capex or opex forecasts. However, under the NER accompanying information can be requested to be resubmitted for non-compliance under clause 6.9.1.

The intention of this final position rule is to facilitate early engagement on a NSP's expenditure forecast methodology and ensure that both the AER and NSPs are aware, in advance, of the information the AER requires to appropriately assess a NSP's proposal. It is intended to bring forward and potentially streamline the regulatory information notice stage(s) that currently occur, as well as to expedite the AER's understanding of the NSP's approach to expenditure forecasting. It does not restrict the AER's ability to use additional assessment techniques if it considers these are appropriate after reviewing a NSP's proposal.

6.5.4 Capex and opex factors

The "best endeavours" clause in the final position rule for the AER to publish in advance analysis on which it proposes to rely, or to which it proposes to refer, for the purposes of the final regulatory determination means that the AER should publish such analysis unless there are time constraints or other reasons why it would be practically impossible for the AER to do so. The way this clause interacts with section 16(1)(b) of the NEL is critical. To the extent there is an inconsistency between those two provisions, the final position rule is not intended to override the NEL, and indeed could not. The AER still has an obligation under the NEL provision to inform the relevant NSP of material issues under consideration and to give the NSP a reasonable opportunity to make submissions in respect of them.

As mandatory considerations, the AER has an obligation to take the capex and opex factors into account, but this does not mean that every factor will be relevant to every aspect of every regulatory determination the AER makes. The AER may decide that certain factors are not relevant in certain cases once it has considered them. In respect of the capex and opex factor that will be added which clarifies that the AER may consider additional factors, any additional factor must be notified to the relevant NSP prior to the NSP submitting its revised proposal.

In respect of the factor to be added which will allow for the AER to have regard to the extent to which NSPs have considered what consumers seek, there are various ways this could be relevant. For example, it may be the case that a majority of affected consumers are unhappy with the visual impact of a proposed new line. If the NSP engages with consumers, it may decide that the best way to address the concerns of consumers would be to build the line underground, even if this is a more expensive option. When the AER considers the NSP's overall capex proposal, it should take into account that the proposed option will provide a higher quality of service in line with consumers' preferences and willingness to pay, above less expensive options which fall below the level of service demanded by consumers. In general, a NSP that has engaged with consumers and taken into account what they seek could reasonably expect the AER to take a more favourable view of its proposal. The Commission expects that over time NSPs and the AER will, through their regulatory proposals and draft and final revenue determinations, develop examples of good practice by NSPs in engaging with consumers.

7 Capex incentives

Summary

- Incentives to seek efficiencies decline during regulatory periods and there is a lack of supervision of capex above the allowance.
- The Commission's approach to addressing these problems is to provide the AER with a number of "tools" which it can apply. These tools will include:
  - capex sharing schemes to be designed by the AER;
  - efficiency reviews of past capex, including the ability to preclude inefficient expenditure from going into the RAB up to an amount that is equal to the amount of expenditure above the allowance; and
  - deciding whether to depreciate the RAB using actual or forecast expenditure to establish a NSP's opening RAB.
- These tools should be viewed alongside the ability of the AER, on an ex ante basis, to scrutinise effectively, and if necessary amend, proposed capex as part of the determination process to set efficient allowances in the first place.
- An overall capex incentive objective describes what the capex incentive regime, as a whole, aims to achieve. The AER will be required to take into account a number of principles and factors when designing and applying the capex incentive tools.
- In addition, regardless of whether a NSP spent more than its allowance, the AER has the ability to preclude expenditure from being rolled into the RAB to the extent that expenditure comprises:
  - inefficient related party margins; or
  - capitalised expenditure as a result of within period changes to the NSP's capitalisation policy.
- Reviews of efficiency of past capex should not be seen as diminishing the role of ex ante incentives. Rather, such reviews are to address a gap in the lack of supervision of capex that has occurred. The ability to reduce the capex rolled into the RAB is intended for obvious cases of inefficiency, and not as the main means of achieving efficient levels of capex.
- A review of efficiency of past capex for the purpose of identifying inefficient expenditure to preclude from the RAB may initially consider benchmarking information and focus on the governance processes and procedures of the NSP. A NSP that follows good practice and governance should be able to demonstrate that its capex is efficient. The presence of a strong ex ante incentive could also provide a high level of assurance that capex is efficient.

Difference between draft rule and final position rule

- The AER will only be able to preclude capex from going in the RAB from the

first regulatory year after the capex incentive guidelines commence. Any capex incurred prior to this time will not subject to this provision.

- The AER will be required to set out in the capex incentive guidelines its approach to assessing whether capitalised expenditure is consistent with the NSP's capitalisation policy.

7.1 Introduction

The role of capex incentives is to encourage NSPs to incur efficient levels of capex - that is, to spend no more than necessary for a given level of reliability and broader service quality. Currently, a NSP is required under the NER to forecast its requirements for capex for the forthcoming regulatory control period. In the regulatory determination, the AER either approves this forecast or does not approve it and replaces it with its own forecast which then becomes the allowance.[227] This allowance is the basis of an incentive for a NSP. If a NSP spends more than its allowance, it bears the costs of this expenditure above the allowance for the remainder of the period.[228] Conversely, if it spends less than its allowance it retains the benefit for the rest of the period.

The AER claimed that the NER provide an incentive for NSPs to spend more than efficient levels of capex for a regulatory control period.[229] This is claimed to be the case particularly where the NSP's allowed rate of return was higher than its actual cost of capital and where the NSP was responding to non-financial incentives it may face. The AER proposed to prescribe in the rules an adjustment to the RAB roll forward such that a NSP could only recover 60 per cent of the cost of any over expenditure (the 60/40 sharing mechanism).[230] It also requested that it be given the discretion to roll forward the RAB using depreciation based on actual or forecast capex as a means of providing an additional incentive. The AER currently has this discretion in Chapter 6 (distribution) but not in Chapter 6A (transmission).

In addition to the broader capex incentive issue, the AER considered that the NER provide an incentive for NSPs to inefficiently incur capitalised related party margins and to replace opex with capex through changes to their capitalisation policies during a regulatory control period.[231]

The remainder of this chapter is structured as follows:

- section 7.2 summarises the Commission's position in the directions paper and draft rule determination;

---

227 The AER does not approve augmentation capex for TNSPs in Victoria; this is determined instead by AEMO.

228 The cost the NSP bears is the cost of financing the extra capex, so these costs are for depreciation incurred and foregone return on the capex.

229 AER, Rule change request, Part B, 29 September 2011, p. 38.

230 In this chapter, phrases such as capex 'going into the RAB' or being considered at the 'RAB roll forward' are generally referring to the RAB which is adjusted and locked in for the next regulatory control period; Id., p. 40.

231 Id., pp. 53-56; AER response to AEMC queries on AER network regulation rule change proposals, 1 February 2012, pp. 7-10.

- section 7.3 summarises the submissions received in response to the Commission's draft rule determination;
- section 7.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- section 7.5 provides the guidance on the final position rule.

7.2 Directions paper and draft rule determination

7.2.1 Background analysis

In the draft rule determination the Commission did not consider that capex incentives in the NER provide an incentive for NSPs to spend more than their allowance. It noted in the directions paper that a NSP could make a judgement on a forward looking basis as to the possible difference between its allowed cost of capital and its true cost of capital. This could provide a basis to support an overspend, but capex incentives should not be designed to address cost of capital matters. However, there are factors outside of the NER that may provide incentives for capex beyond the allowance.[232]

Following on from this, the Commission identified two key issues with capex incentives in the NER. These were that:

- the incentive to make efficiency improvements declines during the regulatory control period, which has implications for the timing of capex and substitution between opex and capex; and
- capex above the allowance is subject to a lack of regulatory scrutiny, which means that there is a risk that any expenditure above this allowance may be inefficient.[233]

In addition, further work undertaken for the Commission by Parsons Brinckerhoff identified that there were a number of potential drivers for overspends during a regulatory control period by NSPs. These included for example corporate governance, project delivery risks and uncontrollable events. The Commission observed that the majority of these drivers could be mitigated or at least partly controlled. Some drivers, however, such as unexpected growth in demand for new connections and compliance with unanticipated regulatory obligations or requirements appeared harder to control than others.[234]

Parsons Brinckerhoff considered that the ability to defer expenditure was one of the ways in which some of the more uncontrollable factors might be mitigated. Similarly, it suggested that a NSP was likely to look more closely at options for deferring capex the closer it gets to exceeding its allowance. Parsons Brinckerhoff also noted that:

232 AEMC, *Consolidated Rule Request - Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. iii.

233 AEMC, *Consolidated Rule Request - Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, pp. 34, 40, 43.

234 Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 2 August 2012.

"In practice actual project costs will be both more than and less than original regulatory submission forecasts, so the net effect is an increase in the business's ability to offset overspending in one area against unpredicted savings or efficiencies realised in another in order to stay at or below the regulated allowance levels.

The exception to this is where low probability high impact events such as extreme weather events, or geopolitical economic shocks have a material effect on Capex. Such exceptions would be better handled by dedicated regulatory tools such as Capex re-openers.[235]"

Nothing in the work that Parsons Brinckerhoff undertook indicated that the current regulatory framework provides NSPs with an incentive to overspend their allowances. However, Parsons Brinckerhoff noted that insufficient regulatory oversight would strengthen the potential for capex overspends through a lack of consequences.[236]

Further work undertaken by the Commission also provided support that the NER provides an incentive to defer capex to the end of a regulatory control period - there was some evidence that both the Victorian DNSPs and Ausgrid had deferred capex until the end of a period.[237]

7.2.2 Overall approach

The Commission's approach to addressing these problems was to provide the AER with a number of "tools" which it can apply as it considers necessary to provide adequate incentives for NSPs to spend capex efficiently. These tools include:

- capex sharing schemes;
- reviews of efficiency of past capex; and
- whether to depreciate the RAB using actual or forecast expenditure to establish a NSP's opening asset base.

These tools should be viewed alongside the ability of the AER, on an ex ante basis, to scrutinise effectively, and if necessary amend, proposed capex as part of the determination process to set efficient allowances in the first place.

The Commission considered that the AER is generally best placed to determine which of the tools can be best used to create incentives for individual NSPs rather than specific approaches being included in the NER. The flexibility inherent in the proposed approach would allow the AER to tailor the incentives to individual NSPs and adapt them over time. This recognises that the best incentives for efficient capex may not be the same for all NSPs or the same over time. However, with greater discretion, there must also be appropriate accountability and transparency to help provide certainty for stakeholders and confidence that the outcomes are in the best interests of consumers.

235 Id., p. 33.

236 Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 22 June 2012, p. 33.

237 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 123-124.

In seeking to provide this accountability and transparency the draft rule provided for an overall objective for capex incentives that was consistent with the NEO and RPP. This objective describes what the capex incentive regime, as a whole, should aim to achieve. It guides the AER in the development and application of the capex incentive tools. It is also relevant for the appeal body to consider this objective when assessing any merits reviews on elements of the capex incentives regime.

In addition, the Commission determined that the AER should be required to set out its approach to capex incentives in guidelines. This is where the AER would set out the approach to capex sharing schemes, how it would undertake efficiency reviews of past capex and how it would determine whether to use actual or forecast expenditure for the purpose of depreciating the RAB. The draft rule also required the AER to set out how its approach to capex incentives overall met the capex incentive objective thereby requiring it to take a coordinated approach to capex incentives. The specific regulatory determination for each NSP would set out which approaches would apply to the NSP and how.

Finally, the draft rule also required the AER to consider principles in the NER when it develops and then applies each of the tools.

7.2.3 Capex sharing schemes

Capex sharing schemes allow for the sharing of efficiency gains and losses from capital expenditure between NSPs and consumers. In general regulators have approached such schemes by allowing NSPs to retain a set portion of any efficiency gains they make and bear a set portion of any efficiency losses it incurs against the benchmark. Often the benchmark is the allowance set by the regulator. The ratio of sharing of the efficiency gains and losses between the NSP and consumers is known as the incentive rate. The AER could use capex sharing schemes to set incentives so that the most efficient NSPs earn the highest rewards and those that are inefficient are penalised.

The Commission identified the following benefits with capex sharing schemes in the draft rule determination:

- they encourage appropriate network investment;
- they encourage NSPs to look for efficiencies, such as by innovation;
- they provide an incentive for NSPs to reveal their efficient costs; and
- they can be designed to provide for a continuous incentive, that is, the incentives could be set so that the incentive power is the same no matter in which year of a regulatory control period an investment is made.

In this way, a capex sharing scheme can give the AER greater confidence that capex going into the RAB is efficient.

The Commission noted one potential problem with capex sharing schemes is that it can be difficult to identify whether reductions in capex are from efficiency gains or inefficient deferral. A capex sharing scheme should not encourage actions that would later lead to degradation of network quality and consequent reductions in service quality. It determined that while there may be difficulties in applying these schemes, the benefits should outweigh these difficulties. On balance, it considered there is room for further innovation in this area.

To provide for certainty the Commission considered that the AER should be required to take into account some principles in designing and applying capex sharing schemes. Importantly, the Commission did not support a principle that a capex sharing scheme should be continuous. Although in most cases a continuous incentive is preferable to a declining incentive it considered a principle of this nature could discourage some schemes which are appropriate. For example, a non-continuous scheme may be relevant when considered alongside the other capex incentive tools such as the reviews of efficiency of past capex.[238]

Similarly, the Commission did not consider it appropriate that the AER be required to consider whether a scheme should be "mathematically symmetrical".[239] Such an approach would be overly prescriptive and could prevent some schemes that would be beneficial.

The Commission proposed that the AER should be able to apply schemes in a different way to different NSPs or even to apply different schemes to different NSPs. This would enable the AER to tailor its approach to individual NSPs. So, for example, the AER could apply what were regarded as stronger incentives for NSPs that traditionally spend more than their allowance and weaker incentives where the AER is concerned about inefficient deferral into future regulatory control periods. For the avoidance of doubt, the AER can also develop different schemes for DNSPs and TNSPs.

7.2.4 Reviews of efficiency of past capex

Reviews of the efficiency of past capex generally encompass the regulator determining whether to allow the future recovery of incurred capex. Reviews of the efficiency of past capex are found in many other jurisdictions, and have been widely adopted in Australia.[240]

The Commission took the view in the draft rule determination that reviews of efficiency of past capex are the most direct way of addressing the lack of supervision problem since they give the regulator the chance to check that the capex to be recovered is efficient. In addition, the risk of an inability to recover for inefficient expenditure would provide an incentive for NSPs to avoid inefficient capex. Ex ante incentives may not always provide adequate assurance that capex is efficient. A further check that what is rolled into the RAB is efficient would therefore be in the long term interests of consumers. The review of efficiency of past capex should also assist the AER in determining an appropriate ex ante allowance by permitting it to better understand

---

238 A constant incentive power is relevant in capex in order to provide an equal incentive to invest in each year of a regulatory control period. Anything other than an equal incentive may provide incentives for NSPs to defer expenditure, even where it is not efficient to do so. In addition a declining incentive in capex and a constant incentive in opex may encourage inefficient substitution between opex and capex.

239 In this context, mathematical symmetry refers to an improvement or decline in capex relative to a benchmark which is of the same absolute value accruing the same reward or penalty in absolute value terms.

240 Id., p. 134.

how efficient a NSP has been in the previous period and what projects it has undertaken. It should also improve understanding of the reasons for any overspends.

Importantly the Commission considered that if a NSP is well run and its management has in place robust processes for deciding which capex projects to undertake and regularly reviews and reassesses its capex program it should have nothing to fear from a review of its efficiency. Indeed, such a review should act to give the regulator greater confidence about the efficiency of the NSP's future capex projections. It was not convinced that the evidentiary burden for the AER would be any different from the evidentiary burden that the AER has when it considers ex ante allowances.

The Commission proposed two elements to the review of efficiency of past capex tool:

- Reducing the amount of capex to go into the RAB; and
- Statement on the efficiency of past capex.

Reducing the amount of capex to go into the RAB for inefficient expenditure

The Commission proposed in the draft rule determination that the AER could only reduce the amount of capex to go into the RAB as a result of a review of efficiency of past capex if the NSP had spent more than its allowance for the relevant period. In addition, the amount of expenditure that the RAB could be reduced by would be restricted to the amount of any expenditure above the allowance for the same period. It would be the AER's decision as to whether it considers it appropriate in the specific circumstances to exercise this power.

The Commission considered that setting the best possible ex ante allowance for capex is important, and that the use of ex ante incentive mechanisms for capex has the potential to provide important incentives for efficiency and innovation in capex that may not occur if reliance was placed on reviews of the efficiency of expenditure after it has occurred. Therefore, it is appropriate for NSPs to only be at risk of capex not going into the RAB if they have overspent the ex ante allowance. This approach would also mitigate any potential for an increase in regulatory risk as a result of the introduction of this tool.

In addition, the Commission considered that if the capex undertaken is the same or very similar to that which the NSP set out in its regulatory proposal then the ex ante assessment of the projects should provide a degree of confidence about the likely efficiency of the expenditure below the allowance. That is, while the nature of the actual capex undertaken need not be identical to what was included in the ex ante allowance, that allowance represents an efficient quantum and expenditure below this amount could be expected to be efficient at an overall level.

Further, given that the ex ante allowance, as a total, represents a forecast of an efficient level of expenditure for the NSP there should be little need for the NSP to spend above this amount in normal circumstances. As the Parsons Brinckerhoff report indicated, while there are often unexpected additional costs for a NSP during a regulatory control period, there will also be unexpected reductions in costs.[241] In addition, the NSP should be able to take mitigating actions, such as re-prioritising capex, to avoid

241 Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 2 August 2012, p. 33.

spending over its allowance, or seek a cost pass through if the relevant test is met. Indeed, on this basis, the Commission suggested there was an argument that no capex above the level of the ex ante allowance should be rolled into the RAB. However, to accommodate unforeseen circumstances where a NSP legitimately spent more than its allowance, the AER should have the ability to make an assessment of the amount of any overspend that may be rolled into the RAB.

In this way, the focus in the draft rule on the overall amount to be rolled into the RAB was intended to encourage the AER to undertake a review of the efficiency of the total capex incurred by the NSP during the specified period rather than just looking at individual projects. The Commission noted that in undertaking a review the AER could consider, among other things, whether the NSP could have avoided spending more than its allowance for the period by deferring projects through re-prioritisation. The draft rule was intended to allow the AER to use a range of analytical techniques to assess the efficiency of capex including benchmarking and the assessment of individual projects. The AER could also consider the effectiveness of the NSP's planning and prioritisation processes for capex to try and gain assurance about the robustness of its decision-making.

The Commission proposed that the AER should set out in the capex incentive guidelines whether and how it intends to undertake reviews of efficiency to determine whether to reduce the amount of capex to go into the RAB. This approach should take into account the other tools it has.

The draft rule determination set out three key elements of the draft rule.

First, it is significant that the test in the draft rule that the AER must apply in determining whether to reduce the RAB as a result of inefficient expenditure is essentially the same as it is for assessing forecasts of capex on an ex ante allowance - that is, whether or not the expenditure reasonably reflects the capex criteria. This was the appropriate test for the efficiency of capex determined by the AEMC in 2006 and it continues to remain valid. The AER now has several years of experience in applying this test and a body of regulatory precedent has been developed.

Second, in determining whether to reduce the amount to be rolled into the RAB the AER should only take into account information and analysis that the NSP could reasonably be expected to have had access to at the time it undertook the capex.

Finally, whilst an AER decision to reduce the amount of capex to go into the RAB as a result of an inefficient capex overspend would not itself be a constituent decision, it would form part of the constituent decision as to the opening value of the regulatory asset base. As a result, this reduction would be subject to the same consultation process as the determination process and, more significantly, merits review.[242] It is important for accountability that a NSP be able to seek an appeal body's review of any decision to reduce its capex rolled into the RAB in this way. While the decision would be subject to merits review, the Commission considered it is very important that any review of the AER's decision considers as a minimum the totality of its approach to capex incentives. This is because a decision that focussed only on the outcomes of the review of

242 What is subject to merits review in the future will depend on any changes agreed by the SCER after considering the LMR Panel report.

expenditure after it has been incurred, but did not have regard to, for example, any ex ante sharing mechanisms, may reach a conclusion that is not consistent with the overall capex objective and the NEO.

Statement on the overall efficiency of capex being rolled into the RAB

In addition to allowing the AER to reduce the amount of capex to go into the RAB as a result of a review of efficiency of past capex, the Commission proposed in the draft rule determination that the AER be required to make a statement on the overall efficiency of capex going into the RAB in its draft and final determination for each NSP. This would require the AER to consider the overall efficiency of capex going into the RAB for all NSPs, not just those that have spent more than their allowance. This recognises the principle that capex below the allowance can still be inefficient.

The Commission considered the obligation to make a public statement on the efficiency or otherwise of what is going into the RAB may be useful in terms of providing information and analysis to consumers and their representatives. Undertaking the review itself could be considered beneficial as a complement to ex ante reviews of capex. For a start, it is common practice that these reviews are carried out at the same time as the ex ante allowances are determined for the next regulatory control period. There are good reasons for this. As Brattle has observed in respect of the task of conducting reviews of the efficiency of past capex:

> "in practice, this task is frequently carried out in parallel with reviewing capex forecasts, for example through the use of technical consultants, and perhaps because both tasks require the same data and expertise.[243]"

This obligation was incorporated as part of the overall approach towards a greater focus on the efficiency of NSPs in the NER. In line with the overall approach of giving the AER greater discretion and allowing flexibility, few requirements were included in the draft rule around how the AER must undertake this task. For consistency the overall test for efficiency is the same as that to be applied where the AER considers whether to make a reduction to the capex to be rolled into the RAB, and the same as that currently in the rules for the assessment of an ex ante forecast. The AER should, when it develops its Regulatory Information Notice (RIN), consider the information that it will require to assess the efficiency of capex that has been undertaken during the regulatory control period.

7.2.5 Depreciation

The Commission engaged Economic Insights to provide advice on the incentive effects of using actual versus forecast depreciation when rolling forward the RAB. Economic Insights designed a model to measure how much benefit is retained by a NSP over the life of the asset if it is able to make a saving against the capex allowance or how much is lost if the NSP overspends. This is the "incentive power" and is the portion of any efficiency saving that the NSP keeps. Similarly if the NSP overspends relative to the allowance, it is the proportion of that cost which it bears. The incentive power was

243 The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 54.

calculated for asset lives of 10, 20, 30, 40 and 50 years using both forecast and actual depreciation for comparison.[244]

The results of Economic Insights' modelling indicates:

1. The incentive power under an actual depreciation approach is higher than the incentive power under a forecast depreciation approach. That is, a NSP will have a stronger incentive to minimise capex relative to the allowance under an actual depreciation approach;
2. The incentive power under an actual depreciation approach differs depending on asset class whereas it is the same for all asset classes using forecast depreciation;
3. The incentive to make any savings relative to the allowance declines through the regulatory control period and by year five results in no incentive to make savings.[245]

The modelling results confirmed the theoretical assessment of the relative incentive effects of depreciation approaches and analyses put forward in submissions.[246] Consequently, Economic Insights stated that:

> "using forecast depreciation may be a preferable default as the use of actual depreciation is a second best substitute for having a capex EBSS [efficiency benefit sharing scheme], creates an incentive to substitute away from short life assets at a time when they may be becoming increasingly important to achieving efficient energy market outcomes and creates an incentive for NSPs to over-inflate their capex forecasts.[247]"

However, Economic Insights also conducted a review of recent Australian regulatory practice and found that the approach to depreciation varied across and within jurisdictions with regulators citing different reasons for using their chosen approach. In contrast, actual depreciation is the norm in the overseas jurisdictions surveyed. As a result, Economic Insights stated that:

> "It has not been a case of 'one size fits all' and the approach used in each jurisdiction reflects the relative issues and concerns that have evolved in that jurisdiction.[248]"

Economic Insights thus concluded that it would be desirable to accord the AER flexibility in making the choice of depreciation approach in transmission as it currently has in distribution rather than prescribe a particular approach.

---

244 Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, pp. 14-15.

245 Note these results will differ slightly depending on the time of year it is assumed that capex is undertaken. Economic Insights have assumed that capex is incurred at the end of the year (Id., p. 14).

246 ENA, Directions Paper submission, 16 April 2012, p. 33 and ENA, Directions Paper submission, Attachment C, 16 April 2012, p. 8.

247 Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, p. 42.

248 Id., p. 33.

Further, the Commission decided that it was appropriate for the AER to have principles that it must take into account when exercising discretion on depreciation.

Therefore, the principles reflected the fact that depreciation is one component of a broader capex incentives arrangement, and that the incentives provided by the choice of depreciation methodology should be coordinated with other incentives for a NSP. For example any capex sharing scheme will be relevant, as this will directly increase the power of the incentive. The power of the incentive for opex is also a relevant consideration to the extent that opex or elements of opex can be substituted with capex. The view was taken that it was undesirable to have incentives to reduce opex without corresponding incentives to reduce capex such that any reductions in opex can be offset by investments in capex. The draft rule determination also noted the importance that incentives to reduce capex do not provide an incentive that could lead to a decline in service standards below the level valued by customers; the incentives provided by the STPIS should also be considered.

It was noted that the differing incentive rates for assets with economic lives of different lengths under the actual depreciation approach will affect whether it is appropriate to have these differing incentives to the extent that they are substitutable.[249] This was because, should they be substitutable, it may distort investment decisions on input use which may ultimately impact consumers. The Commission decided that it was relevant to also consider both the proportional value of short-lived assets in the asset base and their likely current and future strategic importance to gauge the significance of such a risk.

Finally, in considering the appropriate capex incentive, the Commission took the view that it was also relevant to consider the past performance of the NSP. The AER may wish to apply incentives in a different way to a NSP that has historically overspent due to being inefficient compared to one that has underspent.

The view was taken that the objective of the analysis was to arrive at a decision that would be consistent with the incentives for efficient capex under the overall regulatory framework whilst minimising any distortionary effects. The AER would then be required to set out in the capex incentive guidelines the manner in which it proposes to determine whether to use actual or forecast depreciation.

7.2.6 Related party margins and capitalisation policy changes

Related party margins

In a general sense, related parties are companies that are related to a NSP through common ownership.[250] As identified by Covec, some NSPs engage related parties to perform various tasks. The related party margin refers to the difference between the

249 Id., p. 16.

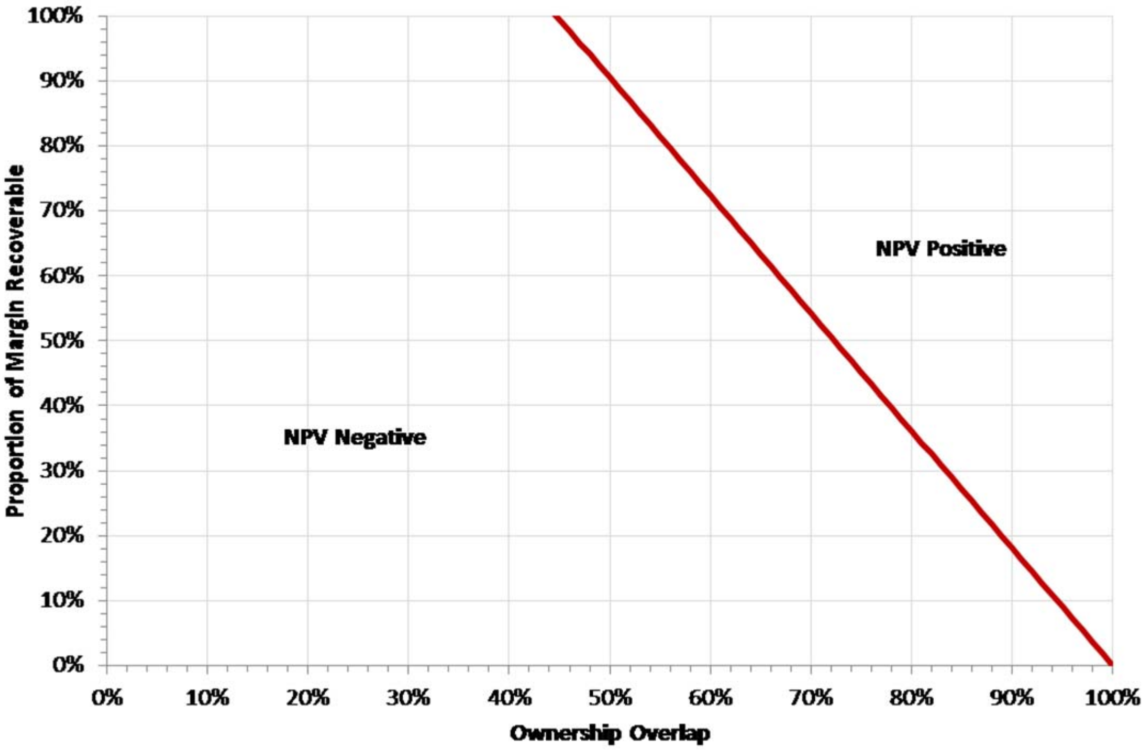
250 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 54.

contract price and the related party's actual direct costs to provide the service and may be capital in nature.[251]

The Commission acknowledged in the draft rule determination that there was a potential incentive for NSPs to incur inefficient capitalised related party margins. It noted that this incentive could be present regardless of whether a NSP spent more than its allowance or not, and even where there were strong ex ante capex incentives in place such as a capex sharing scheme.

The results of a model developed for the Commission by Covec showed that when a NSP owns a large share of a related party it can be financially beneficial for the NSP to pay an inflated margin, even if something less than 100 per cent of that margin is allowed into the RAB.[252] At smaller ownership shares it showed that it is not financially beneficial to pay an inflated margin, even if there is full pass through of the margin into the RAB.[253] This is illustrated in Figure 7.1 below.

Figure 7.1 Incentives to pay related party margins



Source: Covec, *Analysis of the Use of Related parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, p. 21.

---

251 Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers*, Report for the AEMC, 31 May 2012, p. 1.

252 Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers, Report for the AEMC*, 6 June 2012, p. iii.

253 Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers, Report for the AEMC*, 6 June 2012, p. iii.

The Commission also referenced analysis undertaken by the AER on this issue.[254] It suggested that this incentive could encourage NSPs to enter into commercial arrangements that are not the most efficient. It noted that the AER and Essential Services Commission of Victoria (ESCV) both felt that there was a need for additional measures to address excessive related party margins.[255] To encourage NSPs to use the most efficient business structure the Commission determined that this issue should be addressed.

The Commission considered that the issue should be dealt with by reviewing the capex after it is undertaken. It therefore proposed to give the AER discretion to reduce the RAB by an amount that reflects the difference between:

- the margin that was paid; and
- the margin that the AER considers would have been paid if the related party margin had been referable to arrangements that had been on arm's length terms.

This is consistent with the capex factor in the NER that the AER must have regard to in determining the ex ante capex allowance.[256] The Commission considered that the AER should have this discretion regardless of whether the NSP spent more than its overall allowance. As noted above, a NSP could gain from inflating related party margins when it spends less than in its allowance as well as when it spends more than its allowance.

The Commission considered that a flexible or NSP-specific approach to determining the efficiency of related party margins would be optimal to recognise the differing incentive power in different circumstances. It put forward that the AER’s current approach as described in the Covec report may lack the flexibility to take account of NSP specific circumstances.[257] That is, the AER could better tailor incentives to reflect the different circumstances, and so far as is reasonably possible provide an incentive for NSPs to deliver services in whichever way is most efficient, eg in house, related party providers or third party contractors. The Covec model was an example of how this approach could be developed.

The Commission proposed to require the AER to set out its approach to determining the efficiency of related party margins in the capex incentive guidelines. This would give NSPs and other stakeholders a chance to provide input on the AER's approach outside of the regulatory determination process, promote consistency in the application of the rule between NSPs, and provide greater certainty to NSPs as to how the AER will apply the rule.

Capitalisation policy changes

The Commission accepted that there was a potential incentive for NSPs to capitalise expenditure during a regulatory control period and thus recover the same expenditure

254 AER, Directions Paper submission, 2 May 2012, p. 28.

255 For a summary of the measures undertaken by the AER and the ESCV see Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers, Report for the AEMC*, 6 June 2012.

256 See for example clause 6.5.7(e)(9).

257 Covec, *Analysis of the Use of Related parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, pp. i, 8-9.

twice: once in forecast opex and again through depreciation and return on capital once the expenditure is rolled into the RAB.[258]

Similar to related party margins, the Commission proposed to give the AER discretion to reduce the RAB by an amount that represents expenditure that has been capitalised as a result of within-period changes to the NSPs capitalisation policy. As per related party margins, the AER should have this discretion regardless of whether the NSP has spent more than its overall capex allowance not. This is because a NSP may gain from changing its capitalisation policy regardless of whether it spends more than its allowance or not. The Commission suggested that in general a NSP should be able to avoid having to capitalise expenditure as a result of a change in its capitalisation policy. First, changes to the capitalisation policy in the first two to three years of a forthcoming regulatory control period should be less likely on the basis that they could have been included in the earlier regulatory determination. Second, any changes that a NSP wants to make in the final two to three years of a regulatory control period could be delayed until the start of the next regulatory control period.

7.3 Submissions

This section provides a broad overview of submissions received on the draft rule determination. Specific issues that were raised in response to the draft rule determination are considered in section 7.4.

While NSPs support giving the AER the ability to apply a variety of tools they consider that having a capex incentive objective in the NER is unnecessary given the existence of the NEO.[259] Where they commented, other stakeholders were supportive of the overall approach taken in the draft rule determination.[260]

There was broad support from stakeholders for enabling the AER to develop a capex sharing scheme as one of the capex incentive tools.[261] However, NSPs maintain that the AER should at least be directed to consider the desirability of a continuous and symmetrical incentive in developing these schemes.[262]

There were mixed views on reviews of efficiency of past capex. NSPs maintain that allowing the AER to reduce the RAB as a result of a review of the efficiency of past capex would add to regulatory uncertainty and risk and may therefore encourage NSPs to inefficiently defer or avoid capex. They also note the administrative cost of the reviews. They suggest that if reviews of the efficiency of past capex are to be allowed for

---

258 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 150.

259 ENA, Draft Rule Determination submission, 4 October 2012, pp. 50-51.

260 AER, Draft Rule Determination submission, 5 October 2012, p. 13; IPART, Draft Rule Determination submission, 2 October 2012, p. 2; MEU, Draft Rule Determination submission, 4 October 2012, p. 25; Energy Australia, Draft Rule Determination submission, 15 October 2012, p. 2.

261 See, for example, ENA, Draft Rule Determination submission, 4 October 2012, p. 55.

262 Ibid; The Commission defines a continuous incentive as one where the incentive power is the same no matter which year of a regulatory control period an investment is made. It considers that mathematical symmetry refers to an improvement or decline in capex relative to a benchmark which is of the same absolute value, accruing the same reward or penalty, in absolute value terms.

then there should be more guidance in the NER as to when and how the AER should apply them.[263]

The majority of other stakeholders that commented are broadly in support of reviews of efficiency of past capex.[264] The IPART, MEU and the SA Minister for Mineral Resources and Energy consider that the mechanism should be broadened to allow the AER to reduce the amount of capex to go into the RAB when a NSP has spent within its allowance.[265] On the other hand, the EUAA and UnitingCare Australia are sceptical about the effect that reviews of efficiency of past capex might have due to the practical difficulties for the regulator in undertaking them.[266] There was also a concern that NSPs may be able to claim higher rates of return as a result of the mechanism.[267]

Few stakeholders commented on the decision to give the AER discretion to use actual or forecast expenditure for the purpose of calculating depreciation to establish the opening regulatory asset base. Grid Australia supports the AER having this discretion.[268] Jemena suggest that forecast expenditure should be the default approach.[269]

Stakeholders broadly support the Commission's approach for dealing with capitalised related party margins and capitalisation policy changes.[270]

7.4 Analysis

This section responds to issues raised in submissions to the draft rule determination and sets out the Commission's reasoning for its final position.

7.4.1 Overall approach

The capex incentive objective

The Commission maintains that the capex incentive objective in the draft rule is appropriate. The ENA's comment that the objective requires the AER to ensure that "no more than" efficient costs are recovered which is inconsistent with the RPP to provide a reasonable opportunity to recover at least efficient costs does not take into account that the objective is a goal that the NER aims to achieve and not a requirement .[271] Further, the RPPs themselves are not requirements but matters that have to be considered by the AER in making a regulatory determination. There are a number of principles which for

263 Id., pp. 50, 59-60.

264 See, for example, Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 3; Origin, Draft Rule Determination submission, 4 October 2012, p. 1.

265 IPART, Draft Rule Determination submission, 2 October 2012, pp. 1-4; MEU, Draft Rule Determination submission, 4 October 2012, pp. 4, 21-23; SA Minister for Mineral Resources and Energy, Draft Rule Determination submission, 15 October 2012, pp. 1-2.

266 EUAA, Draft Rule Determination submission, 3 October 2012, pp. 13-14; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 13-14.

267 Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 13-14.

268 Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 10.

269 Jemena, Draft Rule Determination submission, 4 October 2012, p. 20.

270 See, for example, Id., p. 15; ENA, Draft Rule Determination submission, 4 October 2012, p. 63.

271 ENA, Draft Rule Determination submission, 4 October 2012, p. 51-52.

some matters have to be weighed up because they suggest weight be given to some factors that may be in conflict.

Content of the capex incentive guidelines

As identified in section 7.2.2 the Commission's general approach is to provide the AER with discretion as to the tools that it should use to provide for appropriate capex incentives and how it uses these tools. This allows the AER to tailor incentives to individual NSPs and adjust them over time. Requiring the AER to set out the criteria that it would use to select the mechanisms it would apply to each NSP as put forward in submissions by NSP would reduce the flexibility inherent in the proposed approach.[272] For example, it could inappropriately restrain the AER from applying or not applying particular mechanisms to particular NSPs at the time of a determination. That said, the AER could elect to provide criteria in the guidelines if it wished to do so.

The process of applying the capex incentive guidelines

The Commission considers that the existing approach to the application of incentive schemes in Chapter 6 of the NER is appropriate for the application of capex sharing schemes and the AER's decision on whether depreciation should be calculated using actual or forecast expenditure for establishing the opening RAB . That is:

- the AER would set out its proposed approach at the framework and approach stage;
- the AER could change its approach during the regulatory determination process; and
- the NSP may propose a different approach during the regulatory determination process.

This will enable a different approach to be adopted if, during the regulatory determination process, it becomes apparent that another approach is more optimal. For example, the AER might want to change its approach to the application of any capex sharing scheme after having received and assessed a NSPs regulatory proposal. Similarly, a NSP may want to propose a different approach in developing its regulatory proposal. However, in general the Commission expects that the application of these aspects of the capex incentive guidelines will be determined at the framework and approach stage in practice. The Commission therefore does not support the position of SA Power Networks, CitiPower and Powercor that the AER should be required to make a final decision on the application of any capex sharing schemes and depreciation at the framework and approach paper stage.[273]

The AER would decide at the time of a regulatory determination on whether to reduce the amount of capex to go into the RAB as a result of a review of the efficiency of past capex. This is discussed in more detail in section 7.4.3.

272 Id., p. 52.

273 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 21.

7.4.2 Capex sharing schemes

The Commission maintains that providing principles that require the AER to consider the need for a continuous and symmetrical incentive in developing a capex sharing scheme could discourage some schemes which are appropriate. This is particularly relevant when considering the capex regime as a whole. For example, the AER might want to adjust the strength of the incentive in certain years of the period to account for possible incentives regarding the timing of expenditure as a result of only allowing the AER to reduce the amount of capex to go into the RAB for inefficient expenditure above the allowance.

If an asymmetric capex sharing scheme is applied, NSPs consider that they should be able to receive compensation through the building block revenue allowance. They suggest that guaranteed service level payments are an example of this approach which provides a positive incentive for NSPs while ensuring consistency with the RPP. While the Commission does not consider that compensation to a NSP through the building block revenue would generally be required for the purpose of a capex sharing scheme, it considers this is something that the AER would decide on at the time of a regulatory determination. This is consistent with the Commission's overall approach to provide the AER with discretion on how to set capex incentives. NSPs also raised this issue in relation to small scale incentive schemes, which is discussed in chapter 9.

7.4.3 Reviews of efficiency of past capex

When the AER can reduce the amount of capex to go into the RAB

As noted in section 7.3, some stakeholders suggest that the AER should be allowed to reduce the amount of capex to go into the RAB when a NSP has spent within its allowance as well as when it spends more. The point was made that just because a NSP has spent less than its allowance it does not necessarily mean that the expenditure is efficient. For example, the reduced spending could have been due to a change in external circumstances during the period. On the other hand, SP AusNet put forward that expenditure as a result of incentives under the STPIS should be carved out when determining whether a NSP has spent more than its allowance.[274]

The Commission does not consider that the review of efficiency mechanism should be broadened as suggested by stakeholders. The approach to be taken is intended to encourage the AER to develop and apply ex ante incentives to reveal the efficient level of capex (including timing of expenditure), so that the review of efficiency of past capex is a last resort option. It would not be desirable that an ex post review becomes the only or main means of ensuring efficient levels of capex. Indeed, the ability to reduce the capex rolled into the RAB is intended for obvious cases of inefficiency, and not as the main means of achieving efficient levels of capex. This approach helps to encourage the development of ex ante incentives. It is also important for the ex ante allowance to have meaning, and if the review of efficiency can be used in the way suggested by these stakeholders the Commission is concerned that both the regulator and the NSP will not focus as much on setting an appropriate ex ante allowance. The ex ante allowance is

274 SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 5.

important because it provides the basis for any ex ante incentives that are put in place and the prices that consumers pay.[275]

In addition, as noted earlier, the Commission considers that the ex ante allowance as a total represents a forecast of an efficient level of expenditure for the NSP and there should generally be little need for the NSP to spend above this amount in normal circumstances. In the event that external circumstances did change to the benefit of the NSP then a well-designed ex ante capex sharing scheme could provide an incentive for the NSP to be efficient. For example, a capex sharing scheme could provide financial incentives for a NSP to be efficient regardless of how much it is forecast to spend as generally the more efficiencies that are made the greater the financial reward for the NSP under such schemes. The ex ante incentive depends in part on how the AER exercises its discretion to implement a capex sharing scheme.

Similarly, the Commission does not consider it appropriate to allow for expenditure relating to incentives provided under the STPIS to be removed from the calculation of the overspending requirement in the NER. A NSP may spend more than its allowance in response to incentives provided under the STPIS and this expenditure may be efficient. However, it should be up to the AER to decide whether to take this into account. If the AER considers this is appropriate then it could set this out in the capex incentive guidelines. For example, the guidelines could set out that the AER would not reduce the amount of capex to be rolled into the RAB if overspending was the result of responding to incentives under the STPIS.

How the AER undertakes the reviews

As set out in the draft rule determination the Commission maintains that it is appropriate that the AER essentially applies the same test for efficiency as the ex ante test in the efficiency review when determining whether to reduce the amount of capex to go into the RAB. In addition, the AER will be required to only consider information that could have reasonably been available to the NSP at the time it undertook the capex.

The Commission notes concerns from some stakeholders on the practical difficulties of reviewing the efficiency of expenditure for the purposes of reducing the amount of capex to go into the RAB.[276] While there can be challenges in such a review the Commission notes that many regulators have undertaken such reviews in the past.

The Commission intends that if a NSP follows good practice and governance for making investment decisions it should be able to demonstrate to the AER that its capex overall is efficient and should be rolled in to the RAB. The presence of strong ex ante incentives for efficient capex could also provide the AER and customers with a relatively high level of assurance that any capex was likely to be efficiently incurred. The final position rule allows the AER to develop ex ante incentives in part because the Commission expects that the use of such incentives could significantly reduce the likelihood of concerns that capex was inefficiently incurred. In this way, any reduction

275 Even though there would be a subsequent adjustment to a NSP's revenue to reflect a decision to reduce the amount of capex to go into the RAB it would not necessarily be the same consumers who benefited from this subsequent adjustment as who paid the original charges.

276 See, for example, EUAA, Draft Rule Determination submission, 3 October 2012, p. 13-14.

of capex to go into the RAB following a review of efficiency would be a relatively rare occurrence.

The Commission considers that good practice and governance would include a NSP being able to demonstrate that it had high quality processes in place to assess and make investment decisions, that it regularly reviewed future investment plans to assess whether they are still appropriate given changes in key assumptions such as demand forecasts, and that it actively sought the views of its customers about investment requirements. Bearing this overall approach in mind the Commission has set out some examples of how the AER could potentially approach undertaking the reviews of efficiency of past capex. Given that the capex incentive objective seeks to ensure that capex to go into the RAB meets the capex criteria in the NER, applying these techniques in a review of efficiency of past capex should enable this to be achieved.

By way of example, the AER could take a layered approach to undertaking the reviews. At the highest level the AER could consider the overall capex for the period under review and compare this expenditure with the expenditure incurred by other NSPs during the period. It could also consider whether capex is consistent with known changes in key factors affecting expenditure levels, such as forecasts of demand.

At the next level the AER could look at the governance arrangements of the NSP including the decision making processes and procedures that it had in place at the time the decision was made to undertake the capex. Better decision making processes for example could have resulted in better prioritisation and deferral of projects. This stage might also involve looking at the contracting processes used by the NSP - how flexible were the contracts entered into, how much contingency did they provide for?

Depending on the outcomes of the AER's assessments in the first two stages the AER could look at some individual projects to see whether any potential concerns identified in some of the governance and contracting arrangements appeared to raise concerns when applied to projects in practice. It could do this assessment for a sample of projects, bearing in mind that the AER can only reduce the RAB by an amount of any expenditure incurred above the NSP's capex allowance.

In extreme cases where the AER had found evidence of very poor governance processes and the initial sample of projects reviewed verified these concerns it may want to undertake a wider review of projects. While this wider review may not lead to any additional reduction in capex rolled in to the RAB it could provide valuable insights for the AER when reviewing a NSPs proposal for the next determination.

The Commission intends that the AER should not be limited to a bottom-up engineering assessment of individual projects to determine inefficiencies although this type of assessment would also have a potential role to play in any review. As explained above the Commission intends that the initial focus of reviews of efficiency of past capex would be on the governance processes and procedures of the NSP.

The Commission agrees with NSPs that the AER should have regard to the other capex incentives and measures that exist when considering the nature and extent of a review of efficiency.[277] In addition, the AER should also have regard to other factors such as

277 ENA, Draft Rule Determination submission, 4 October 2012, pp. 59-60.

the extent to which a NSP may have spent more than its allowance during previous regulatory control periods. The final position rule adequately provides for this by requiring the AER to consider how all of the capex incentive tools taken together are consistent with the capex incentive objective when developing the capex incentive guidelines. This requires the AER to take a coordinated approach to capex incentives.

Capex that is precluded from the RAB that subsequently becomes used and useful

NSPs suggest that the NER need to allow for any disallowed capex to be carried forward where capex is subsequently used and useful.[278] The Commission considers that determining whether capex was subsequently used and useful would be similar to optimising the RAB. As identified in the final determination on a rule change put forward by the MEU, the Commission does not support such a review.[279] Amongst other things this would force the AER to take a project by project or asset by asset approach to reviews of efficiency of past capex assessments. Instead it should be an assessment of the total expenditure incurred. Having said this, the AER could take into account the extent to which it expected capex to later become used and useful in determining the amount of any reduction to capex to go into the RAB if it wished to do so. The AER should set this information out in its capex incentive guidelines.

Review of efficiency of past capex and capex undertaken previously

In its consultation paper on savings and transitional arrangements the Commission set out that the discretion for the AER to reduce the amount of capex to go into the RAB as a result of a review of efficiency of past capex would apply immediately following commencement of the final rule. That is, the AER would have the power to reduce the RAB as a result of a review of past capex as part of any regulatory determination which is made by the AER following the commencement of the final rule.[280]

NSPs did not support this approach. They implied that it would not be fair and reasonable and was not consistent with section 33 of schedule 2 of the NEL.[281]

The Commission considers that although NSPs should be undertaking capex in their current regulatory control periods in an efficient manner it agrees that it may not be reasonable to apply the mechanism to all capex incurred in the current regulatory period. This is because NSPs would not have known that the amount of capex to go into the RAB could be reduced as the result of an efficiency review when they undertook the capex for the whole of the current regulatory control period. Therefore NSPs may not have kept information and records that they would have if they had known that they would have been subject to a review. For example, a NSP whose next regulatory control period begins in 2015 would be subject to the possibility of having its opening RAB for

278 ENA, Draft Rule Determination submission, 4 October 2012, p. 60; Jemena, Draft Rule Determination submission, 4 October 2012, p. 20.

279 AEMC, *Optimisation of Regulatory Asset Base and the Continued Use of Fully Depreciated Assets*, Rule Determination, 13 September 2012.

280 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, p. 11.

281 Energex, Draft Rule Determination submission, 4 October 2012, p. 2; Jemena, Draft Rule Determination submission, 4 October 2012, pp. 19-20; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 22-23.

the next period reduced to reflect inefficient capex incurred during its current regulatory control period (2010-2015). The NSP would not have known that it would be subject to an ex post efficiency test until the final rule commences in November 2012 and therefore may not have kept records and information on decision making for example to the level that it would have prior to then had it have known that it would be subject to a review.

An input into the consideration of the level of information and records that a NSP considers that it needs to maintain will depend on how the AER proposes to undertake the review as set out in the capex incentive guidelines. This is particularly relevant given that NSPs have no experience of the AER undertaking these types of review before. For these reasons, the Commission considers that it is appropriate that the AER should not be able to reduce the amount of capex to go into the RAB as a result of a review of efficiency of capex for capex that was incurred prior to the AER's first capex incentive guidelines being in place. However, as set out in the consultation paper on savings and transitional arrangements the Commission maintains that the final rules when made should apply to all NSPs as soon as possible.[282] Therefore, the AER will be able to reduce the amount of capex to go into the RAB as a result of a review of efficiency of capex for capex that was incurred in the first regulatory year after commencement of the AER's first capex incentive guidelines. In addition, this change does not affect the requirement for the AER to make a statement on the efficiency of the capex to go into the RAB as part of its draft and final regulatory determination for each NSP - this provision will have immediate effect and will apply to all capex spent by the NSP during its current regulatory control period.

On the basis that rules that give effect to this approach are not needed on an ongoing basis, they are not included in the final position rules and instead will be included in the transitional rules to be published on 29 November 2012.

The version of the guidelines that will have effect at the time the AER undertakes a review

NSPs have also commented on the version of the guidelines that the AER should be required to apply to reviews of efficiency of past capex. NSPs say the capex incentive guidelines in place at the beginning of the regulatory control period in which the capex being assessed was incurred should be applied - not those that were in place at the time it undertakes a review of efficiency. The ENA and SA Power Networks, CitiPower and Powercor make similar comments in relation to the rate of return guidelines, which are discussed in chapter 4, and related party margins, which are discussed below.

The Commission does not consider it is appropriate to provide this level of precision in the NER. This approach is inflexible and could lead to inefficient outcomes. For example, it would lock-in old versions of guidelines even where there have been improvements to the guidelines to recognise the experience of the AER in applying previous guidelines. It could also result in the AER applying different versions of the guidelines to different NSPs which could be difficult to do in practice and administratively burdensome. Further, the Commission notes that Chapter 6 of the

282 AEMC, Consolidated Rule Request – Economic Regulation of Network Service Providers, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, p. 7.

NER provides that the AER should indicate how transitional issues are to be dealt with when it develops and changes its guidelines.[283] The same provision will be added to Chapter 6A of the NER as part of this rule change. This is the appropriate means of dealing with any transitional issues arising from changes to the capex incentive guidelines.

7.4.4 Related party margins and capitalisation policy changes

Related party margins

The Commission maintains that the test in the draft rule for determining whether the RAB should be reduced for capitalised related party margins is appropriate. This is a specific issue pertaining to related party margins and is separate from the general review for efficiency. Among other things the trigger mechanisms are different. The AER does retain the discretion to make a reduction to what is added to the RAB and it might be expected that if a margin not on arm's length terms could otherwise be shown to be efficient the AER would consider this. The Commission's general starting point is that margins on arm's length terms are likely to be efficient. It therefore does not agree with Jemena that the test should be on the prudency and efficiency of the expenditure.[284]

ENA suggests that the AER should be required to take into account the capex incentive guidelines that are in place when the arrangements that gave rise to the margin being paid or payable by the NSP (not those that were in place at the time it undertakes a review of efficiency).[285] Similarly, SA Power Networks, CitiPower and Powercor consider that the AER should be required to apply the capex incentive guidelines in place at the beginning of the review period in relation to related party margins. As noted in section 7.4.3 the Commission considers it appropriate that the AER should apply the guidelines in place at the time of the review and that the AER has scope to consider transitional issues when revising guidelines.[286]

SA Power Networks, CitiPower and Powercor also wanted more detail as to what the AER should set out in the guidelines on its approach to determining the efficiency of related party margins.[287] The Commission does not consider that more detail in the NER on this issue is appropriate. It should be up to the AER to develop its approach on this issue taking account of the NEO, the RPP and the capex incentive objective.

Capitalisation policy changes

The draft rule provided that the AER could reduce the amount of capex to go into the RAB for expenditure that was capitalised and was not consistent with the NSP's capitalisation policy at the time of the regulatory determination in which the expenditure was incurred. NSPs consider the draft rule would remove the

283 NER clause 6.2.8(d).

284 Jemena, Draft Rule Determination submission, 4 October 2012, p. 15.

285 ENA, Draft Rule Determination submission, 4 October 2012, pp. 53-54.

286 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 25.

287 Id., p. 25.

inappropriately classified expenditure from the RAB without acknowledging it as opex.[288] NSPs suggest this is important because:

- actual opex is an important input into future allowances; and
- it will allow for the proper application of the efficiency benefit sharing scheme (EBSS).

The Commission agrees that actual opex is an important input into future allowances. Indeed actual opex incurred during any preceding regulatory control periods is a factor that the AER has to take into account in deciding whether it is satisfied with a NSP's opex forecast in its regulatory proposal.[289] In principle, the Commission considers that it should be up to the AER to determine whether capitalised expenditure that is not allowed to go into the RAB should be recognised as actual opex for the purpose of setting the opex forecast for the next period. This would be determined by the AER through the regulatory determination process and will depend on the approach adopted by the AER in relation to the opex forecasts. It should also be up to the AER to adjust the allowances in the EBSS to take account of any capitalised expenditure that is not allowed to be rolled into the RAB. Again, it is appropriate that this be determined through the regulatory determination process.

The draft rule did not require the AER to set out its approach to determining whether expenditure has been capitalised consistently with the NSP's capitalisation policy in the capex incentive guidelines. This was because the Commission considered that this test did not require any further specification. In its response to the draft rule determination NSPs suggest that the AER should be required to set out its approach to capitalised expenditure in the capex incentive guidelines.[290] The Commission accepts that it is appropriate for the AER to set out its approach to assessing capitalised expenditure in the capex incentive guidelines given that this is a part of the capex incentive regime and that the capex incentive guidelines should set out the AER's overall approach to capex incentives in the guidelines.

7.5 Guidance on final position rule

The final position rule provides the AER with the capacity to use a range of different tools to provide assurance that the level of capex being incurred by NSPs is as efficient as reasonably possible. Given the scope of discretion being afforded to the AER, the Commission considers it helpful to provide some guidance as to how it intends the provisions of the final position rule to operate.

7.5.1 Overall approach

The capex incentive objective was formulated to reflect the ex ante test for efficiency of capex that was developed by the Commission in 2006. This means that capex incentives should be designed with the aim that only capex that is efficient should be rolled into the RAB. Efficiency in this context would include trading off investment in new and

288 ENA, Draft Rule Determination submission, 4 October 2012, p. 63.

289 NER clause 6.5.6(3)(5) and 6A.6.6(e)(5).

290 ENA, Draft Rule Determination submission, 4 October 2012, p. 53.

replacement assets, maintenance of existing assets and other options such as demand side management.[291] It also includes the efficient timing of capex and whether expenditure incurred reflects that which would have been incurred by a prudent NSP. The objective should not act as a mandatory requirement or a prohibition, but a source of direction for the capex incentives regime.

7.5.2 Capex sharing schemes

Process

The process of developing and applying a capex sharing scheme will be as follows:

- the AER may develop a capex sharing scheme or schemes that can be applied to any NSP. This will be set out in the guidelines, which should also explain how the scheme is consistent with the overall capex incentive objective;
- the AER must set out in the framework and approach paper for a NSP its proposed approach to applying any capex sharing scheme to the NSP;
- the NSP proposes how any applicable capex sharing scheme should apply to it in its regulatory proposal. For example, there may be elements that the NSP may propose that are discretionary in the scheme; and
- the AER determines how any applicable capex sharing scheme will apply in its draft and final regulatory determinations for the NSP. For example, the AER could use this stage to set any incentive rate that is to be applied for a NSP.

Principles

The principles will reflect that the neutral position for a NSP achieving its regulated cost of capital is a NSP that is meeting its allowance and that broadly a NSP will be rewarded for improvements in efficiency that result in expenditure less than the allowance and penalised for expenditure more than the allowance. In this way, penalties should not be imposed on NSPs that undertake capex in an efficient manner. That is, the scheme should encourage NSPs to seek out and achieve efficiency improvements over and above those in the allowance. Those improvements should then be appropriately shared between NSPs and consumers. This means that achieving such efficiency improvements under the scheme should be expected to be net present value (NPV) positive for NSPs while also providing benefits for consumers.

While the principles will provide for rewards and penalties, and will not require that there be mathematical symmetry between those rewards and penalties. That is, NSPs should be rewarded with a set portion of any efficiency gains and should be penalised by a set portion of any efficiency losses. For example, a scheme may be designed so that where a NSP is able to undertake its capex program for a regulatory year at $1 million less than the benchmark, 50 per cent of this saving, or $500,000, is reflected in higher revenues. The same scheme may provide that where there is $1 million over the benchmark, the NSP bears the cost of 30 per cent and only $700,000 is recovered in revenues. The AER is required to explain in its guidelines how the scheme is consistent with the capex incentive objective.

291 In practice, efficiency can only be measured by comparison to other companies.

The final position rule requires the AER to take into account the interaction of the scheme with other incentives such as those relating to service performance, demand management and opex. For example, the AER should consider the impact of the mechanism on substitution of capex for opex. Similarly, it might want to consider adopting a higher powered scheme where it has access to extensive information on service standards. The AER must also take into account the capex objectives, and where relevant the opex objectives in the NER. These objectives include complying with regulatory obligations such as reliability and service standards.

In deciding whether to apply any scheme it has developed and the details of the scheme that should apply, the AER will also be required to take into account all of the same principles and factors that it has to take into account in designing a scheme. In addition, it will have to take into account the capex incentive objective and the relevant circumstances of the NSP. So for example, the AER could take into account the spending history of the NSP when determining whether to apply a scheme and the nature of any scheme. The final position rule does not require that any scheme meet all of the factors that the AER is required to take into account, only that the AER takes into account or has regard to the factors. The Commission would expect the AER to explain how it had taken into account or had regard to the various factors.

The principles can accommodate different types of schemes. Examples of schemes that would be permitted by the final position rule are described in Appendix A. These examples are not meant to limit the way the AER approaches setting capex incentives but to illustrate particular ways that the provisions on capex sharing schemes in the final position rule could be implemented.

7.5.3 Reviews of efficiency of past capex

Reduction for inefficient expenditure

The final position rule allows the AER to make a reduction in respect of any overspend in relation to the regulatory allowance for a specified period. The process requires that the AER must set out in its capex incentives guidelines how it will approach this.

The years that comprise this period will not match any one regulatory control period. This is because at the time a regulatory proposal is submitted, data on actual capex will not yet be available for every year of the current regulatory control period. This means that the years which comprise the period for analysis should be compared with the relevant regulatory allowance on a like for like basis, for example the same constant dollars and discount factor should be used. Under the current timing for the regulatory process and the extended timeframe set out in the final position rule, three years of data from the current regulatory control period will be available at the time of the regulatory proposal assuming a five year regulatory control period. The final position rule intends that the period that will be assessed to determine whether an overspend has occurred and reviewed for the purpose of reducing the amount of capex to go into the RAB should comprise:

- the years in the current regulatory control period for which the AER has actual capital expenditure data at the time the NSP submits its regulatory proposal. For example, years one to three of a regulatory control period where the regulatory control period is five years; and

- the last two years of the previous regulatory control period which will not previously have been the subject of a review of efficiency by the AER.

Even though the AER is likely to obtain the data for actual capex of the second last year of the current regulatory control period *during* the regulatory process, there may not be sufficient time for the AER to consider this. Therefore, the actual capex during the second last year of the regulatory control period will not be considered until the following regulatory determination.

As identified above, the AER will be required to set out the manner in which it will determine the amount of any reduction in more detail in the capex incentive guidelines. This could include considerations such as:

- the extent to which projects were evaluated against, and satisfied, the relevant regulatory test;
- the amount of any penalty already imposed on the NSP in respect of the expenditure through a capex sharing scheme, as well as whether the operation of a capex sharing scheme would reduce the likelihood of inefficient overspending. The Commission intends that a reduction to the amount of capex to go into the RAB following a review of efficiency by the AER should be a last resort measure and that primary reliance could be placed on an ex ante incentive to provide assurance that capex is incurred efficiently; and
- the effect of the use of actual rather than forecast depreciation in the RAB roll forward mechanism.

In determining whether an overspend has occurred, the allowance for each year is determined based on the AER's relevant regulatory determination that includes that particular year. Since this will include years in different regulatory control periods different regulatory determinations will be relevant for determining the overall allowance for the years being considered. The overspending requirement will be determined by comparing the capex allowance for the relevant period against total capex incurred. Any decisions relating to cost pass-throughs, capex re-openers and contingent projects are to be applied to adjust the allowance for the purposes of determining if there has been an overspend. In respect of cost pass throughs, this will mean that the AER will need to know the proportion of any cost pass through amount that represents capex, as opposed to opex. The AER may wish to use its information gathering powers to have this information provided with a cost pass-through application. The amount of any overspend determined will be the maximum amount that the AER can reduce the RAB by as a result of a review of efficiency of past capex.

The Commission notes that a NSP could in theory be penalised twice for the same inefficient expenditure if the cause of an overspend was due to capitalised related party margins and/or capitalised expenditure not in accordance with the NSPs capitalisation policy. However, it is expected that the AER would use its discretion appropriately in this circumstance. Similarly, in line with the general approach taken in this rule change, the AER could decide to not reduce the amount of capex going into a NSP's RAB if, after deducting for inefficient related party margins and capitalised expenditure not in accordance with the NSPs capitalisation policy, the NSP would have spent within its allowance. The AER could set this out in the capex incentive guidelines.

As described above, in determining whether expenditure incurred was efficient, the AER must only take into account information and analysis that the NSP could have reasonably been expected to have considered or undertaken at the time that it undertook the relevant capex. The NSP should only be judged on material reasonably available to it at the time, though this would include material available not just at the start of a project but also during it.

If for example the NSP chose the most efficient pole design in 2008 but further studies in 2010 indicated a different pole design would have been more efficient, it would depend on when the project was carried out relative to 2010 in the regulatory control period whether it may be appropriate for the AER to take into account these further studies. As another example, in coming to a decision on whether work was undertaken efficiently the AER could only use unit costs at the time the expenditure was incurred. The AER could not take into account advancements in technology which may have reduced the unit costs of expenditure. One source of information that the AER could use is published forecasts of demand, for example the transmission annual planning report, and it would be reasonable for the AER to expect that NSPs actively and regularly reviewed capex plans based on the most up to date forecasts of demand.

The Commission considers that benchmarking information such as a comparison of actual capex incurred by NSPs during the period would violate the hindsight principle and would not be a basis on its own for the AER to reduce the RAB. However, as discussed in section 7.4.3, this information could be used as an initial sense check to give an indication as to whether further scrutiny of capex was required. In addition, benchmarking information that was available to the NSPs at the time it undertook the capex could be used by the AER for this purpose. For example, if the benchmark cost of building a particular asset at the start of a regulatory control period was $1m but the NSP spent $1.5m the AER could use this information to reduce the amount of capex to go into the RAB if the NSP could not provide justification why it paid more than the benchmark cost. This is because it could be expected that the NSP would have had access to this information at the time that it undertook the capex.

The AER should set out its reasons in the regulatory determination for reducing the capex that would otherwise be rolled into a NSP's RAB consequent upon a review of the efficiency of past capex. If the AER determines a capex overspend has occurred but determines not to make a reduction, the AER should also explain this in the determination in accordance with the consideration of the overall efficiency of what is rolled into the RAB. The Commission intends that if a NSP follows good practice and governance for making investment decisions it should be able to demonstrate to the AER that any capex it has incurred beyond the allowance is efficient and should be rolled in to the RAB.

The AER will not be able to make a reduction to the amount of capex to go into the RAB as a result of a review of efficiency of past capex where the capex was incurred before the commencement of the first capex incentive guidelines. Expenditure incurred in the current period in the first regulatory year after the commencement of the first capex incentive guidelines however may be subject to an efficiency review. This means that, for a NSP whose next regulatory control period commences on 1 January 2015 the AER could reduce the RAB as a result of inefficient expenditure incurred from 30 November

2013 to 31 December 2014 of the current regulatory control period assuming that the AER's capex incentive guidelines commence on 29 November 2013.[292]

Consideration of the overall efficiency of what is rolled into the RAB

The statement on the efficiency of capex to be rolled into the RAB will be independent of the discretion to reduce the capex that is rolled into the RAB. In practice, the AER is likely to conduct these assessments together and use the review of the efficiency of the totality of the capex as part of its consideration of whether to make a reduction in respect of any overspend.

The final position rule enables the AER to undertake these reviews in the manner it considers appropriate. In particular, these may be tailored to the circumstances of a particular NSP. A review may be different based on the AER's knowledge of how a particular NSP has undertaken capex in the past, for example. Alternatively, if a NSP has overspent in a particular regulatory control period the AER might choose to undertake a more extensive review than if it had underspent. The review could be based on a top down or bottom up analysis, or some combination of the two. It is expected that NSPs will include justification that past capex is efficient in their regulatory proposals.

7.5.4 Depreciation

The final position rule enables the AER to choose the depreciation approach with regard to a number of principles. The principle that refers to the other incentives a NSP has to incur efficient capex is intended to prompt consideration of the totality of those incentives, including incentives outside the NER which may be specific to the NSP. This will provide a guide as to whether additional incentives are required to encourage efficient capex. For the final position rule the Commission accepts the ENA's proposal to broaden the named incentives from the STPIS to any scheme or other incentive. As well, the principle which relates to the efficiency of past capex will also provide a guide as to whether additional incentives are required.

To the extent that additional incentives are deemed appropriate, the principle requiring an examination of the substitution effects of short and long life assets is designed to assess the materiality of the potential distortionary effects of increasing the power of the incentive using depreciation by applying an actual approach. The extent that short-lived assets, such as information technology, can be physically substituted with long-lived assets, such as poles and wires, to achieve similar outcomes in network management should be considered in terms of the ability and the incentive to do so. In turn, a consideration of the benefits of such asset types is intended to address the potential strategic importance of such asset types to avoid potential distortions even if the relative size of the asset class is a small proportion of the capex program.

Substitution possibilities between opex and capex should also be considered for potential distortions as they are included in the capex factors. A consideration of capex factors is to encourage consistency with the overall capex incentive objective. Finally,

292 However, it should be noted that the review of this expenditure would occur as part of the regulatory determination process for the subsequent regulatory control period as this is when the AER would have actual data for this period.

the purpose of the requirement to consider the capex incentive guidelines is to promote internal consistency with the principles and approach included in the guidelines in any decision of the approach to depreciation.

7.5.5 Related party margins and capitalisation policy changes

The final position rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to deal with related party margins that do not reflect margins that would have been incurred if, in the opinion of the AER, the arrangements had been on arm's length terms. It will be up to the AER to determine whether arrangements that were entered into by the NSP and a third party reflect arm's length terms. Similarly, it will be up to the AER to determine what the margin would have been if it considers the arrangements do not reflect arm's length terms. The AER will be required to set out its proposed approach to related party margins in the capex incentive guidelines. The Commission considers a flexible or NSP specific approach might be adopted to recognise that the incentive power differs in different circumstances and that the Covec model may assist the AER in developing this approach.

The capex incentive guidelines could also include providing greater clarity on what the NSP should report under the information provision relating to this issue.[293] If NSPs do not provide the information required by the AER under the information provision relating to related party margins then the AER may be able to seek the required information through a regulatory information notice.

Similarly, the final position rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to reflect capitalised expenditure as a result of changes to the NSPs capitalisation policy during the regulatory control period.

The AER can reduce the capex that would otherwise be rolled into the RAB for these expenditure types regardless of whether a NSP has spent more than its capex allowance. Similarly, the amount by which the AER may reduce the capex that would otherwise be rolled into the RAB for these expenditure types is not limited to the amount of any expenditure above the allowance.

To assist the AER in exercising this discretion the final position rule will require a NSP to include in its regulatory proposal information on margins paid or expected to be paid to related parties and information on expenditure that has been capitalised by NSPs otherwise than in accordance with the capitalisation policy submitted to the AER as part of the NSP's regulatory proposal. As a corollary, the final position rule will require NSPs to provide their capitalisation policy with their regulatory proposal. The AER will need this as a reference point in respect of actual expenditure at the time of the next determination. In practice, the AER could take the approach that it will approve capitalised expenditure where a NSP provides audited statements that its policy has not changed. Although not required, it could set this out in the capex incentive guidelines.

As identified in section 7.4.4 the Commission considers it appropriate that the AER should take into account disallowed capitalised expenditure when considering past opex of a NSP to determine its opex allowance. This should be considered as part of the regulatory determination process.

293 Final position rule NER clause S6.1.1(6).

By comparison with the general review of efficiency of past capex, for the purpose of related party margins and capitalisation policy changes the AER has more discretion to consider capex where actual data isn't available.

On the other hand, the same arrangements as those for the general review of efficiency of past capex apply in terms of the capex that is subject to assessment following the commencement of the rule. That is, the AER will not be able to make a reduction to the amount of capex to go into the RAB where the capitalised related party margins or capitalised expenditure was incurred before the commencement of the first capex incentive guidelines. Expenditure incurred in the current period in the first regulatory year after the commencement of the first capex incentive guidelines however may be subject to this review.

8 Regulatory determination process

Summary

- The Commission has taken a holistic approach to address broad issues with the current regulatory determination process, with the purpose of improving the consumer engagement process, providing the AER and other stakeholders with an adequate opportunity to consider all relevant and significant material, and making NSPs more accountable.
- To this end, the following incremental changes will be made to the current process that are within the scope of the rule change request:
  - the NSP will provide a consumer-targeted overview paper with its regulatory proposal;
  - the AER will publish an issues paper outlining its preliminary key issues to assist the consumers to focus their resources;
  - the AER will hold a public forum to allow consumers and other stakeholders to engage with the AER and NSP on the regulatory proposal and issues paper;
  - the NSP will identify to the AER specific confidentiality claims in its regulatory proposal;
  - the AER will report such confidentiality claims on its website;
  - the AER will report on its website where it receives late or out-of-scope material from the NSP;
  - the timeframe for the regulatory determination process will be extended by commencing it four months earlier;
  - the time for the NSP to prepare its revised regulatory proposal will be increased;
  - a discretionary cross-submissions stage to target specific issues arising from submissions on the draft regulatory determination or revised regulatory proposal will be introduced;
  - the framework and approach paper will be made optional on particular matters that have been addressed in a previous framework and approach paper; and
  - changing the service classification and formulaic expression of the control mechanism will be based on unforeseen circumstances after the framework and approach paper has been published.

Difference between draft rule and final position rule

- In the draft rule, the framework and approach stage and the regulatory determination process were to commence six months earlier than the current arrangements. The final position rule further optimises this timeframe so that the framework and approach stage will be completed and

the regulatory determination process will commence four months earlier than the current arrangements.

- In the draft rule, the framework and approach stage on a particular component or components would have only been triggered at the AER's discretion. The final position rule allows the NSPs to also trigger the framework and approach stage on a particular component or components in addition to the AER.

8.1 Introduction

Regulatory decision-making involves thorough consideration of the regulated business' proposal.[294] It involves providing opportunities for the regulated business and interested stakeholders, including consumers and consumer representative groups, to make submissions to the regulator.[295] It also entails allowing reasonable time for full and thorough analysis of the submissions and the regulator's intermediate decisions.[296] To facilitate this, the NEL sets out the manner in which the AER is to perform its economic regulatory functions or powers.[297] In addition, the NER specify the processes that the AER, NSP and other stakeholders are required to follow as part of the regulatory determination process.[298] A key to effective regulation is the reduction of regulatory risk by providing transparent and timely processes for regulatory determinations.[299] Ensuring clarity around a number of procedural issues provides greater certainty to market participants, makes them more accountable to a clearly prescribed process, and reduces delays in regulatory decision making.[300] This chapter addresses issues raised by the AER regarding the regulatory determination process, which are outlined below.

8.1.1 Regulatory determination process

To reduce regulatory error under the current regulatory determination process, all stakeholders are permitted to provide submissions at various points throughout the process. The AER was concerned that NSPs are undermining the process by providing material that should be part of an initial or a revised regulatory proposal later in the process in the form of submissions.[301] This does not provide other stakeholders and the AER sufficient time to scrutinise this material.

294 This point was also made by the Commission in 2006. See AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 108.

295 Ibid.

296 Ibid.

297 Ibid.

298 Ibid.

299 Ibid.

300 Ibid.

301 In this chapter, unless clearly specified, references to "regulatory proposal" are to regulatory proposals in Chapter 6 and revenue proposals in Chapter 6A. Where references to "revenue proposal" are referred to, these are revenue proposals in Chapter 6A.

The AER proposed placing limitations on NSP submissions to address this issue. In particular, the AER proposed rules that would prevent the NSP from making a late initial or revised regulatory proposal in the form of submissions.[302]

8.1.2 Confidentiality claims

The current confidentiality arrangements were designed to balance the need for stakeholders to have access to the information upon which regulatory decisions are made and the need to protect confidential information. Without giving the appropriate protection for certain information, such disclosure could commercially harm the NSP or third parties. The AER was concerned that NSPs have been claiming that more information is confidential than is necessary. This, in turn, denies other stakeholders the opportunity to respond to, make an informed comment upon, and scrutinise, all relevant information.[303]

The AER proposed amendments to the NER which would, amongst other things, provide the AER with the discretion to give such weight as it considers appropriate to confidential information. This would apply in an initial or revised regulatory proposal, or in any submissions given to the AER.

8.1.3 Framework and approach

The framework and approach paper is specific to the distribution regulatory determination process. It provides the DNSP and other stakeholders with an opportunity to be consulted on the AER's likely approach to certain elements of the distribution regulatory determination.

The AER proposed changes to the content of the framework and approach paper, and when it may be departed from in a final regulatory determination. This would include:

- removing consultation on the application of incentives schemes in the framework and approach paper;
- allowing the AER to change the control mechanism, in addition to service classification, following the framework and approach paper; and
- changing the threshold for departing from the service classification and control mechanism in the framework and approach paper to "unforeseen circumstances".

8.1.4 Chapter structure

The remainder of this chapter is structured as follows:

- section 8.2 summarises the Commission's position in the directions paper and draft rule determination;
- section 8.3 summarises the submissions received in response to the Commission's draft rule determination;
- section 8.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and

302 AER, Rule change request, Part B, 29 September 2011, p. 89.

303 Id., p. 90.

- section 8.5 provides guidance on the final position rule.

8.2 Directions paper and draft rule determination

8.2.1 Background

In the directions paper, the Commission set out objectives which it considered underpin the regulatory determination process:

- the AER should be given enough time to scrutinise material provided by a NSP in its initial and revised regulatory proposals. This includes providing a clear period of time to consider all relevant and significant material submitted during a regulatory determination process prior to making the final regulatory determination;
- the regulatory determination process should provide a reasonable opportunity for a NSP and other stakeholders to comment on and scrutinise material submitted by each party;
- the NSP should have sufficient time to prepare its revised regulatory proposal and should submit as much relevant information as possible in its revised regulatory proposal;
- in circumstances where a restriction is imposed on the content of the revised regulatory proposal, the NER should not permit this restriction to be circumvented through the use of submissions; and
- the regulatory determination process should encourage dialogue between the AER, the NSP and other stakeholders, particularly consumers, to establish a common understanding of the issues.

In the draft rule determination, the Commission considered that these key objectives are consistent with the AEMC's Chapter 6A rule determination. They are also consistent with the NEO as they will likely lead to more transparent and robust decision-making, and therefore increased certainty for investment in significant infrastructure for the provision of services.

In addressing the broader issues identified in the directions paper, the Commission decided in the draft rule determination to proceed with the following options:

- reporting late or out-of-scope submissions;
- commencing the regulatory determination process earlier, including extending the timeframe for the NSP to prepare its revised regulatory proposal;
- introducing a discretionary cross-submissions stage;
- requiring a mandatory issues paper from the AER and an overview paper from the NSP;
- identifying and reporting confidentiality claims in the regulatory proposal; and

- making the framework and approach paper an optional stage.[304]

These options were considered to enhance the transparent and timely processes for regulatory determinations, and increase the robustness of regulatory decision-making. They also would address the broader issue of providing all stakeholders with sufficient time and improving stakeholder engagement during the regulatory determination process.

8.2.2 Late or out-of-scope submissions

The AER characterised the problem as being that NSPs are undermining the process by providing late or out-of-scope submissions where they should have included this in their regulatory proposals, and proposed placing limitations on NSP submissions. In the directions paper, the Commission considered the AER's identification of the problem only highlighted a broader issue with the current regulatory determination process. The process is currently not providing all stakeholders with an opportunity to effectively scrutinise material provided by the NSP where the NSP submits further information later in the process. It also does not provide the AER with enough time to assess all relevant material and to make a decision. This late information is greater than was previously envisaged by the AEMC in 2006. There may be legitimate reasons for the provision of information later in the process, such as new information becoming available to the NSP or a material change in the circumstances. However, an increase in the quantity of late material has an adverse effect on the ability of interested parties to be engaged with the regulatory determination process.

In the draft rule determination, the Commission decided not to restrict the NSP's provision of material during the regulatory determination process. This was because it would create procedural fairness issues by denying the NSP a reasonable opportunity to make submissions, especially where there are legitimate reasons for making submissions. The Commission considered that restricting the NSP from making submissions in respect of the regulatory determination before it is made would create an inconsistency with sections 16 and 28ZC of the NEL. On this basis, the Commission noted that the AER retracted from its original proposal and was open to making modifications to its proposal to avoid any inconsistencies with the NEL.[305]

Other regulators

The AER's problem with receiving information from the NSP which may be late, out-of-scope or voluminous is not unique. Regulators in general are subject to this as part of their regulatory decision-making processes, although there may be differences in the regulatory framework.

In one example provided in the draft rule determination, the New Zealand Commerce Commission was found by the High Court of New Zealand to only be required to have

---

304 It is noted that a framework and approach paper must exist for the prescribed matters, although this may well be the previous framework and approach paper if the approach set out in it remains appropriate.

305 AER, Directions Paper submission, 2 May 2012, p. 66.

regard to submissions received in timeframes that the regulator sets.[306] This was following a judicial review sought by the business against the Commerce Commission for rejecting out-of-scope and/or late submissions.[307]

As a regulator, the AER currently has the discretion to not accept such late submissions from the NSP or any other stakeholder.[308] The Commission understood that the Australian Competition Tribunal has previously stated that the AER must draw a line on its engagement with a NSP or it will fail to meet the imposed deadlines.[309] The Commission encouraged the AER where appropriate to utilise its existing powers that are available for any administrative decision-maker to not accept late submissions.

Reporting on late and out-of-scope submissions

With this in mind, the Commission decided a better approach would be for the AER to report on any late or out-of-scope submissions it receives from a NSP. Making public on the AER's website details of late or out-of-scope submissions from the NSP may be an effective tool to discourage such submissions being made. The use of such a tool would increase transparency in this area in that the AER previously did not need to report that it had received a late submission. This approach may also be seen as creating a reputational risk for the NSP if it does decide to make a late or out-of-scope submission.

Other options

As noted above, part of the reason for late submissions also relates to a shortage of time in the current regulatory determination process. The Commission's proposed changes to the regulatory determination process, including commencing earlier and extending the current timeframe may assist to alleviate the problem.[310]

8.2.3 Confidentiality claims in the regulatory proposal

AER's existing powers

In the directions paper and draft rule determination, the Commission considered that it is important that the probative value of as much of a NSP's initial or revised regulatory proposal as possible is able to be tested with stakeholders. There will almost always be information included as part of a NSP's initial or revised regulatory proposal which is legitimately claimed to be commercially sensitive and confidential. However, the Commission considered it unlikely that all aspects of an initial or revised regulatory proposal could legitimately be claimed to be confidential, partly because the NSP is a monopoly business and therefore does not compete directly with other businesses.

There also appears to be scope for information to be aggregated where concerns about confidentiality for more detailed aspects of information are present. On this basis, it

306 *Wellington International Airport Limited v Commerce Commission* HC WN CIV-2011-485-1031 [21 December 2011], [278]-[293].

307 Ibid.

308 ENA, Consultation Paper submission, 8 December 2011, p. 57.

309 *Application by EnergyAustralia* [2009] ACompT 8, [257].

310 Commencing the regulatory determination process earlier and extending the current timeframe are described in section 8.2.6 of this final position paper.

would be expected that only relatively small parts of the initial or revised regulatory proposal should be commercially sensitive, and therefore confidential.

The NER do not explicitly permit the AER to give less weight to confidential information in an initial or revised regulatory proposal. However, there are existing AER powers under the NEL and common law to use discretion in addressing confidentiality claims in a regulatory proposal. These include:

- giving lesser weight to the information when making a decision;
- aggregating confidential information;
- publishing confidential information if the public benefit outweighs the detriment to the NSP arising as a result of the disclosure of the information; and
- seeking alternative arrangements such as limited disclosure.

The Commission considered that the AER has a broad range of tools at the AER's disposal to assist it in addressing confidentiality claims. The AER should take advantage of its existing discretionary powers.

Limited timeframe

In the draft rule determination, the Commission considered that an additional six months to the current timeframe as discussed in section 8.2.6 should allow the AER more time to consider confidentiality claims in a regulatory proposal. However, the AER considered that extending the timeframe would not address the problem of a NSP making blanket and unsubstantiated confidentiality claims.[311] Therefore, having more information about the reasons for a confidentiality claim may make it easier for the AER to assess the claim. Categories of confidential information, as described below, may assist this.

Categorisation of confidentiality claims and guidelines

In commenting on the directions paper, NSPs proposed a categorisation of confidentiality claims to assist the AER in assessing confidentiality claims.[312] The Commission considered in the draft rule determination that these confidentiality categories are clearly legitimate reasons for claiming confidentiality as they relate to commercial sensitivities, protection of security, or privacy. However, they should not be considered an exhaustive list, which legislation would still require the AER to protect from being disclosed.[313]

Therefore, the Commission proposed to require the AER to develop and consult on guidelines, which would specify the manner in which the NSP can make confidentiality claims in its regulatory proposal. This may include: categories of confidential information; and how the NSP should identify the confidential information. However, the NSP would not be prevented from making confidentiality claims. The guidelines' purpose is to assist the AER when it receives confidentiality claims from the NSP.

---

311 AER, Directions Paper submission, 2 May 2012, p. 71.

312 ENA, Directions Paper submission, 16 April 2012, p. 71.

313 *Competition and Consumer Act 2010* (Cth) s. 44AAF.

Further, by establishing guidelines which clarify the manner in which NSPs are to make their confidentiality claims: NSPs would have a better understanding of the AER's requirements; NSPs would become more accountable when they make confidentiality claims in regulatory proposals; and the administrative burden on the AER would be eased in addressing confidentiality claims.

In addition to the guidelines, the draft rule required the AER to publish on its website information relating to the proportion of the NSP's material that is subject to a claim of confidentiality. This would allow the public to have an understanding as to the proportion of material that has been claimed to be confidential, as well as a comparison of the proportion of material to other NSPs' claims of confidentiality.

Interaction with interested parties

NSPs proposed in their submissions on the directions paper for a non-rule based solution to the issues raised in respect of confidential information in the form of a confidential information protocol.[314] In the draft rule determination, the Commission indicated its support for any initiative that aims to improve stakeholder engagement, without the need for prescription in the NER.

With the introduction of the NSP overview paper, discussed below, the Commission considered that this would be the appropriate place to require the NSP to explain whether and, if so, how it has engaged with consumers. This would assist the AER to determine whether it should take a stricter approach in assessing the confidentiality claims from the NSP and how much weight to place on the document.

It would also encourage NSPs to become more disciplined in only making genuine confidentiality claims, clearly identify confidential information to the AER, and reduce the administrative burden on the AER. Other stakeholders would also benefit from a more transparent process and have a greater opportunity to access relevant information. Overall, this would facilitate as much testing and scrutiny of the initial or revised regulatory proposal as possible, while upholding legitimate claims of confidentiality by NSPs. This would lead to a more well-balanced and robust decision-making process.

8.2.4 Mandatory issues paper and overview paper

Issues paper

Consumer representative groups sought in submissions on the rule change request for better opportunities to be engaged in the regulatory determination process. In the directions paper, the Commission identified a need for improvement in engaging with stakeholders during the regulatory determination process, especially with consumer representative groups. This was consistent with the LMR Panel's view that there are weaknesses in the regulatory determination process for consumer and user participation.[315]

314 ENA, Directions Paper submission, 16 April 2012, p. 70.

315 LMR Panel, *Review of the Limited Merits Review Regime*, Stage One Report, Report for the SCER, 29 June 2012, p. 45.

Therefore, the Commission considered establishing a mandatory issues paper during the time between the regulatory proposal and close of submissions on the regulatory proposal. This was seen to be for the benefit of stakeholders, including consumer representative groups.

The Commission considered in the draft rule determination that the identification of these preliminary issues would assist all stakeholders to make better use of their resources to focus on particular matters when preparing their submissions on the regulatory proposal. It would also encourage further discussion on these issues earlier in the process and before the publication of the draft regulatory determination. The regulator should also benefit from this process because fundamental differences could be identified and resolved earlier in the regulatory determination process and the quality of submissions should improve. This should lead to an overall improvement in stakeholder engagement. For these reasons, the Commission endorsed the mandatory use of an issues paper.

Although optional under the NER, it was acknowledged that the issues paper has never been utilised in practice.[316] This is possibly due to the current limited timeframe between the regulatory proposal and close of submissions on the regulatory proposal. Additional time was therefore provided to the AER to prepare this paper. Using the ESCV's regulatory process as an example, the Commission considered that the AER should be given 40 business days after the submission of the regulatory proposal to make the issues paper.

Overview paper

In the draft rule determination, the Commission also considered the need for the NSP's regulatory proposal to be easier for consumers, including consumer representative groups, to understand. To promote this, the Commission decided that an overview paper should be provided by the NSP. The paper would be subject to preliminary examination together with the regulatory proposal.

The resource intensive nature of the regulatory determination process, especially the volume of information accompanying regulatory proposals and submissions, was recognised. A further burden is placed on resources for consumer representative groups to digest this information and understand the risks, benefits and impacts.

The overview paper would aim to address this by providing a summary of the NSP's regulatory proposal from the NSP's perspective which is specifically directed at electricity consumers. The scope would be to focus on the risks and benefits of the regulatory proposal for electricity consumers. In addition, the paper would outline how the NSP has engaged with consumers and how it has addressed any of their concerns which have been identified as a result of that engagement. Finally, a comparison between the NSP's proposed and current revenue requirements would be made. This was aimed at promoting NSP engagement with electricity consumers earlier in the process. As the NSP overview paper would be consumer-focused, it would need to be presented in plain language that would be easily understood by electricity consumers. Designing the overview paper this way would help to promote better engagement by the NSP with consumers, including consumer representative groups. It would also

316 NER clauses 6.9.3(b) and 6A.11.3(b).

mitigate the disadvantage of limited consumer resources and expertise in the area. This approach would also be consistent with the LMR Panel's Stage One Report findings to encourage earlier consideration of consumers' interests in the regulatory determination process.[317]

Public forum

The Commission considered in the draft rule determination that the requirement to have an overview paper and issues paper should be complemented by a public forum. The benefit of this is that it provides an additional opportunity for stakeholders to seek clarification from the AER and NSP on the NSP's regulatory proposal and the AER's preliminary thinking in the issues paper. Further, the forum should assist stakeholders when they prepare their submissions.

Taken together, the AER issues paper, NSP overview paper and associated public forum should improve the level of understanding of the issues and quality of input from stakeholders. These processes add value by assisting stakeholders to allocate their resources to focus on key issues in the regulatory proposal and on the AER's preliminary views.

Notwithstanding the mandatory public forum, the Commission welcomed any other informal engagement between the NSP and AER with stakeholders.

8.2.5 Cross-submission stage

The AER expressed a concern that NSPs are providing submissions on the draft regulatory determination to which other stakeholders do not have a reasonable opportunity to respond. Equally, it could be argued that other stakeholders may raise issues in their submissions which do not allow the NSP to have a formal opportunity to respond. Presently, under the NER, there are no formal consultation processes available following close of submissions on the draft regulatory determination. That said, the Commission noted in the draft rule determination that the AER has used its discretion at times to consult informally with interested parties prior to making a final regulatory determination.

In the draft rule determination, the Commission considered a formal discretionary cross-submissions process to alleviate problems associated with stakeholders not receiving a reasonable opportunity to respond to an NSP submission, and vice versa. The New Zealand Commerce Commission's cross-submissions stage was examined. It was recognised that this is a discretionary stage in which the Commerce Commission can decide to initiate the process based on a narrow scope of issues raised during the initial round of submissions.[318]

---

317 LMR Panel, *Review of the Limited Merits Review Regime, Stage One Report*, Report for the SCER, 29 June 2012, p. 46.

318 For example, the Commerce Commission allowed for a cross-submissions stage on its process and issues paper in one of its regulatory process with respect to input methodologies for default price-quality paths with respect to electricity distribution and gas pipeline services. This stage followed immediately after close of submissions on the process and issues paper. Later in that same regulatory process, the Commerce Commission allowed for another cross-submissions stage on its draft input methodology. This second cross-submissions stage occurred immediately after close of

The Commission considered the AER's concerns that such a stage could create an additional administrative burden on the AER to consider an additional volume of material as a result of the process, and may disincentivise the NSP from providing a complete revised regulatory proposal and submissions upfront within the current timeframes.[319] These could be mitigated by giving the regulator the discretion to initiate the cross-submissions stage, and limiting the scope of the cross-submissions stage to specified matters that have been raised during first round submissions. It would also give the AER the option to dispense with the process if it considers that it would be unnecessary and to better utilise resources in preparing the final regulatory determination.

Overall, the Commission was of the view that providing the NSP and other stakeholders with an opportunity to respond to each other's submissions on specified matters would likely increase the opportunity for all to comment. It would also likely potentially reduce the volume of material that may have otherwise been provided later in the regulatory determination process, which would have been outside of the consultation period. The AER may also benefit in the cross-submissions stage if the cross-submissions provide clarity to the AER on specified matters that were raised in submissions on the draft regulatory determination.

8.2.6 Timing of the regulatory determination process

In the draft rule determination, the Commission noted that the environment for economic regulation of network services has changed since the Chapter 6A rule determination and 11 months for the regulatory determination process appeared to be inadequate. Further, it was recognised that the new additions to the regulatory determination process in the draft rule would require consequential changes to the existing 11-month timeframe.

In addition, the Commission considered extending the time for the NSP to account for a lack of resources over the Christmas to New Year period that was not previously envisaged in 2006. Nevertheless, the Commission pointed out that the NSP should not circumvent the existing requirements by submitting its revised regulatory proposals late.

The Commission decided to allow for an additional 15 business days to the current 30 business day period in which the NSP must submit its revised regulatory proposal and calibration of the timeframes to address the Christmas to New Year period problem.[320] This should provide the NSP with a more reasonable opportunity to prepare and submit a complete revised regulatory proposal.

---

submissions on the draft input methodology. NSPs support a cross-submissions stage on the basis that this would provide an opportunity for submissions made by different stakeholders to be tested, and lead to a broader debate between the NSP and other stakeholders. For further information, see New Zealand Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths*, Process and Issues Paper, 9 December 2011, pp. 5, 7, 9, 12, 16; New Zealand Commerce Commission, *Draft Input Methodologies for Default Price-Quality Paths*, Consultation Paper, 15 June 2012, p. 5.

319 AER, Directions Paper submission, 2 May 2012, p. 68.

320 The Commission notes that NSPs propose an additional period of between 10 to 15 business days to prepare their revised regulatory proposals.

In the draft rule determination, a total 120 business days, or approximately six months, was added to the existing overall regulatory determination process timeframe. This was to account for the extension in time for existing stages in the process and the addition of new stages. The Commission did not contemplate a shorter additional amount of time as proposed in submissions because it was concerned that this would reduce the AER's decision-making timeframe and impact on the robustness of its decisions. As a result, a NSP would need to submit its regulatory proposal to the AER at least 19 months, instead of 13 months, before the end of the current regulatory period.

The Commission considered that the benefit of commencing the regulatory determination process earlier by six months would allow for: additional processes to promote further stakeholder engagement and transparency; more time for the existing processes, which should lead to more robust decision-making, more comprehensive and timely submissions; and reduce late material. This would outweigh the risk of less accurate and available information for forecasts.

The Commission compared the new regulatory determination process timeframe with other jurisdictions'.[321] Although it was substantially longer than some, it would still be shorter than Ofgem's 24 month timeframe. Nevertheless, a distinction was made between the regulatory process in terms of the degree of prescription in Australia, and historical developments in economic regulation in Australia.[322]

For consistency, the Commission decided to align the regulatory determination process timeframes for transmission and distribution as part of the improvements made to the process. As a result, the changes would include:

- removing the deadline for the making of the draft regulatory determination for transmission where there is currently no such deadline for distribution. This would allow the AER some flexibility in making the draft regulatory determination, which may be desirable given the different individual circumstances of NSPs; and
- changing the deadline for receipt of submissions on the draft regulatory determination for transmission to be no earlier than 40 business days after the publication of the draft regulatory determination. For transmission, the reference date was set at no earlier than 45 business days after the date specified by the AER with respect to the predetermination conference on the draft regulatory determination.

Overall, the AER would still have some flexibility in adjusting the timeframe for specific milestones as it currently does, balanced with the constraint to meet the final deadline for publishing the final regulatory determination.

---

321 The regulators in other jurisdictions considered were IPART in New South Wales, ERA in Western Australia, Commerce Commission in New Zealand, Ontario Energy Board (OEB) in Ontario and Rhode Island Public Utilities Commission (RIPUC) in Rhode Island. For further information, see The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, p. 4.

322 Here, the regulatory determination process starts from the date when a regulatory proposal is submitted to the regulator to the date that a final regulatory determination is made by that regulator. See The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraphs 12 and 27.

8.2.7 Framework and approach paper

Need for a framework and approach paper

In the directions paper, the Commission considered the NSPs' proposal for a new framework and approach paper to be discretionary if there are no material changes to a particular component of the framework and approach paper.[323] In such a case, there would be no need to revisit such component(s), and the then existing framework and approach paper would be sufficient. This is because the consultation on that component(s) would not provide any additional benefit. As a result, the administrative costs would be reduced by making the process more efficient and flexible. In the draft rule determination, the Commission maintained this position.

The Commission considered that, as the administrative decision-maker, the AER should be responsible for deciding whether to trigger the framework and approach paper. It would be at the AER's discretion to determine how much weight should be given to the NSP's input over other stakeholders with respect to initiating a framework and approach paper. However, it would be most likely that the NSP's input would be the most relevant, given that it has the knowledge of its own network and other matters relevant to the forthcoming regulatory period.

For consistency, the framework and approach paper process would also apply to transmission.

Control mechanism - only relevant to distribution

In the directions paper, the Commission took the view that the AER may need some flexibility to adjust the control mechanism following the framework and approach paper when unforeseen circumstances occur. This was because the AER's proposal highlighted the potential mismatch in the thresholds for changing the control mechanism and the service classification following the relevant framework and approach paper for distribution. Following further clarification from the AER regarding the differences between the form of control mechanism and the formulaic expression of the control mechanism, the Commission decided to revisit this issue in the draft rule determination.[324]

The Commission accepted that the amount of time required for a NSP to accommodate changes to the form of control mechanism would be significant. As a result, the form of control mechanism should be fixed in the framework and approach paper. However, if the formulaic expression of the control mechanism was able to be amended, a measure of flexibility would be afforded.

The Commission considered that this would provide sufficient flexibility in being able to change the formulaic expression of the control mechanism during the regulatory determination process, balanced with certainty in fixing the form of the control

323 Under the draft rule, the components will include incentive schemes, service classifications, form of the control mechanisms, formulaic expressions of the control mechanisms, dual function assets, and methodology for forecasting expenditure.

324 Examples of the form of control mechanism can be found under clause 6.2.5(b) of the NER. On the other hand, the formulaic expression of the control mechanism is the formula associated with that form of control mechanism.

mechanism at the framework and approach paper stage. In addition, the formulaic expression of the control mechanism could be changed if the service classification is changed, addressing the AER's concern.

Threshold for changing service classification and formulaic expression of the control mechanism in regulatory determinations - only relevant to distribution

In respect of changes to service classification, the Commission maintained in the directions paper and draft rule determination that the threshold to allow the AER to depart from its framework and approach paper will be in the event of unforeseen circumstances.

The terms "good reasons" and "persuasive evidence" were seen to be unclear and ambiguous, open to differing interpretations, and create unnecessary uncertainty in the process. On the other hand, the threshold of "unforeseen circumstances" was considered to be more definitive, consistent with other parts of the NER, providing a degree of certainty compared to the "good reasons" and "persuasive evidence" thresholds, and allowing the AER some flexibility where "unforeseen circumstances" arise.[325] The "unforeseen circumstances" threshold would not allow for changes due to reasons which ought to reasonably have been considered at the time that the decision was made in the framework and approach paper.

In addition, the Commission in the directions paper and draft rule determination held that the threshold for departing from the service classification should be the same as that for departing from the formulaic expression of a control mechanism. This suggested an "unforeseen circumstances" test for the formulaic expression of the control mechanism as well.

8.3 Submissions on draft rule determination

8.3.1 Regulatory determination process

The AER, MEU, EnergyAustralia and NSPs generally support the proposed changes to the overall regulatory determination process, including commencing the process earlier, the requirement for an overview paper and issues paper, allowing NSPs more time to submit their revised regulatory proposals, and a cross-submissions stage.[326] They consider that this should provide for greater consultation and improve consumer engagement.[327] On the other hand, ESAA suggests that NSPs need to understand how

325 For example, the term "unforeseen circumstances" appears under NER rule 3.7A(p)(3) and clause 11.30.2(I)(3). In addition to this, the term "unforeseen" appears under clauses 5.6.2A(b)(7), 5.6.5C(a)(1), 5.6.5C(b), 5.6.5C(c), and S8.11.1(b).

326 AER, Draft Rule Determination submission, 5 October 2012, pp. 17-18; ENA, Draft Rule Determination submission, 4 October 2012, pp. 3-4; EnergyAustralia, Draft Rule Determination submission, 15 October 2012, pp. 2-3; Jemena, Draft Rule Determination submission, 4 October 2012, p. 9; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 30; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 6; MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

327 AER, Draft Rule Determination submission, 5 October 2012, pp. 17-18; ENA, Draft Rule Determination submission, 4 October 2012, pp. 3-4; Jemena, Draft Rule Determination submission, 4 October 2012, p. 9; SA Power Networks, CitiPower and Powercor, Draft Rule Determination

the AER intends to evaluate NSPs' evidence on how they engaged with consumers, and recover their costs for consulting with consumers.[328]

Consumer representative groups consider the changes may address some concerns and better inform consumers.[329] Requiring NSPs to report on customer engagement and having the AER take this into account may be meaningful if it is equivalent to the negotiated settlements approach used in some states and provinces of the United States of America and Canada.[330] However, they consider that if this is not the case, then these changes will not improve consumer engagement as they would not be empowered to materially influence the outcomes of the process.[331] The additional stages may create an administrative burden for consumer representative groups with limited resources.[332] The Victorian DPI also expressed similar concerns with respect to the administrative burden placed on the AER and stakeholders as a result of an extended timeframe, suggesting that the overall process could be shortened (eg, 12 months for the ESCV) as it has been previously done in other jurisdictions.[333]

NSPs propose further improvements to the process.[334] These include: reinstating submission guidelines for transmission as without this TNSPs would be subject to an administrative burden in changing to the new requirements; separating the deadline for NSP revised regulatory proposals and submissions on the draft regulatory determination from the deadline for stakeholder submissions on the draft regulatory determination, NSP's submission and revised regulatory proposal; and commencing the regulatory determination process in a shorter period than the extended six months to avoid issues of inaccurate and irrelevant information (such as forecasts) in regulatory proposals.[335]

Other more specific issues related to the discretionary cross-submissions stage occurring after submissions on the revised regulatory proposal closes (if any). The AER supported being given the discretion to trigger this stage on specific issues that may not have been subject to consultation.[336] However, the NSPs did not consider that the stage should be discretionary because the AER may not be in a position to identify the significant issues and the NSPs may not have an opportunity to comment on them if the

---

submission, 4 October 2012, p. 30; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 6; MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

328 ESAA, Draft Rule Determination submission, 23 October 2012, p. 3.

329 ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 16-17.

330 Ibid.

331 Ibid.

332 MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

333 Victorian DPI, Draft Rule Determination submission, 2 November 2012, pp. 3-4.

334 ENA, Draft Rule Determination submission, 4 October 2012, pp. 66-68; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 6-7.

335 Ibid.

336 AER, Draft Rule Determination submission, 5 October 2012, p. 18.

stage is not mandatory.[337] They consider that there is sufficient constraint on the NSPs to not provide out-of-scope submissions; even so, a more appropriate constraint on the cross-submissions stage would be to limit the scope of submissions made during the cross-submissions stage, rather than giving the AER discretion to trigger the stage.[338] Alternatively, the cross-submissions stage should be made mandatory if the AER uses its discretion to invite submissions on the revised regulatory proposal.[339]

The NSPs also propose for the final regulatory determination to be completed earlier and to increase the period for submitting the DNSPs' pricing proposals.[340] IPART supports this approach, noting that a rule change request has been submitted to the Commission to address the annual pricing proposal framework.[341]

8.3.2 Confidentiality claims

The AER regards the confidentiality guidelines as a way in which it may outline to the NSP what is required when NSPs make confidentiality claims in their regulatory proposals.[342] Ergon Energy sought further clarification that the categories of confidential information would not refer to personal affairs or personal information because this is already covered under other legislation.[343] Although broadly supporting the Commission's approach, the Consumer Action Law Centre considers that more can be done to improve the way in which consumer representative groups are engaged with respect to confidential information such as developing protocols.[344] On the other hand, Origin considers that there will be no reduction in confidentiality claims in regulatory proposals and seeks more stringent requirements.[345]

8.3.3 Framework and approach

Need for a framework and approach paper

The AER supports the optional framework and approach stage to apply to distribution and transmission.[346] However, the NSPs consider that this stage should be mandatory because: the AER is being given the sole discretion to trigger the stage without equal input from NSPs; the need for NSPs to prepare for new components or changes to existing components in the framework and approach paper, especially with the expanded scope of the framework and approach; and simplicity of drafting.[347] On the other hand, NSPs would accept an optional framework and approach stage if they were

---

337 ENA, Draft Rule Determination submission, 4 October 2012, p. 67; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 30-31.

338 Ibid.

339 Ibid.

340 ENA, Draft Rule Determination submission, 4 October 2012, p. 68.

341 IPART, Draft Rule Determination submission, 2 October 2012, pp. 1, 4-5.

342 AER, Draft Rule Determination submission, 5 October 2012, p. 18.

343 Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 9.

344 Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4.

345 Origin, Draft Rule Determination submission, 4 October 2012, p. 2.

346 AER, Draft Rule Determination submission, 5 October 2012, p. 18.

347 ENA, Draft Rule Determination submission, 4 October 2012, pp. 8, 73-74.

given equal discretion as the AER to trigger the stage, while third party stakeholders can also submit on whether they consider a framework and approach stage is necessary.[348] TNSPs also object to the new requirement for a framework and approach stage in transmission as they consider harmonising the historical differences in forms of regulation and price control for standard control services is unique to distribution, and transmission is already mature and homogenous enough without the need for a framework and approach stage.[349]

Threshold for changing service classification and formulaic expression of the control mechanism in regulatory determinations

NSPs maintain their position that the threshold for changing service classification and the formulaic expression of the control mechanism in regulatory determinations should be based on new evidence becoming available after the framework and approach stage which would justify departure from that stage ie, persuasive evidence.[350] They provide examples where it would be foreseeable, yet would justify a departure, such as: competition in the provision of alternative control services being foreseeable but its impact on the market not being crystallised until after the framework and approach stage; and a contingent project trigger event occurring which would be foreseeable and require a change in the service classification.[351]

8.4 Analysis

As in the draft rule determination, the Commission's general approach to this rule change request has been to provide the AER with more discretion. Unlike rate of return or capex incentives, however, in respect of the regulatory determination process there are less risks of additional prescription in the NER. In particular, there should be less need for regular changes to the regulatory determination process to adapt to changing circumstances. To allow stakeholders to properly plan, certainty is also very important for the regulatory determination process.

Nonetheless, the current NER or final position rule do not prescribe the regulatory determination process on every aspect, and the AER does have discretion in many respects. This discretion may include further consultation when the AER proposes a shift from its draft position, and placing less weight on, or not considering, information that is submitted too late in the process.[352] Further, the NER only provide a framework towards effective engagement; it should be seen as a minimum in terms of the level of engagement. The extent of interaction between the NSP, the AER and other stakeholders is up to those parties. For instance, the AER and NSP should be engaging with each other regularly on an informal basis, including outside of the regulatory determination process. NSPs can, and should, be engaging with consumers and other stakeholders in their network areas outside of the process as well.

348 Ibid.

349 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12-13.

350 ENA, Draft Rule Determination submission, 4 October 2012, pp. 74-75.

351 Ibid.

352 It is noted that section 16(b)(I) of the NEL requires the AER to inform the NSP of material issues under consideration by the AER.

As a general rule, the Commission will not be prescribing in the NER requirements where a regulatory requirement already exists via the NEL or common law. The Commission considers that giving the AER discretions, which are a general function of regulators or are already set out in the NEL, should be avoided where possible. This is especially so where it is clear that they would still exist in the absence of the NER and including them in the NER would not provide any additional value. This general approach avoids any potential conflict between the NER and the NEL or common law, especially if the NEL or common law position were to change in the future.

8.4.1 Regulatory determination process

Consumer engagement

The Commission notes the consumer representative groups' dissatisfaction with the draft rule changes made to the regulatory determination process to meet their need for empowerment in influencing the outcomes of the process.[353] The changes in the draft determination were intended to improve transparency and accountability, increase consultation and therefore scrutiny of information submitted during the process, and provide for more robust decision-making within the scope of the rule change. The Commission does not purport to address larger consumer related issues such as lack of resources, expertise or funding which is, as a number of consumer representatives point out, a role for the policy maker.[354] For instance, the Commission has recommended to the SCER the creation of a national peak consumer body.[355] However, where possible, the Commission will be endeavouring to improve the operation of the rules to assist consumers to be better engaged. The Commission notes that this has not been opposed by any stakeholder throughout the process, but rather has been fully accepted as a given. Therefore, amongst other changes, improving the regulatory determination process will be for the benefit of all parties, especially consumer representative groups, in requiring NSPs to submit overview papers, requiring the AER to publish issues papers, holding mandatory public forums, extending time for consultation, and providing for a discretionary cross-submissions stage. As the Commission noted in its draft rule determination, though, the regulatory determination process only provides a minimum framework in which the AER and NSPs can engage with each other as well as with other stakeholders such as consumers. In the end, it is up to all parties involved to engage in good faith, which the NER cannot prescribe.

With respect to the consumer representative groups' preferred negotiated settlements approach, the scope for full negotiated settlements between consumers and NSPs is beyond what the Commission could reasonably consider being within scope for this

353 ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 16-17.

354 Ibid.

355 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 155.

rule change process.[356] Instead, changes to effect the consumer representative groups' preferred approach are better addressed outside of this rule change process as part of the broader development of a stronger consumer role. This rule change process can be considered as part of this broader development.

Commencement of the regulatory determination process

The Commission notes the concerns expressed by some NSPs that the earlier the regulatory determination process commences, the less accurate and relevant the forecast expenditure and other information will be in the NSP's regulatory proposal.[357] The Commission maintains that improvements in the regulatory determination process will require it to commence earlier than the current arrangements. This will avoid reducing the existing length of time for the AER to prepare its draft and final regulatory determinations as it could impact on the robustness of its decision-making. However, the Commission has identified ways to further optimise the timing without necessarily impacting on the AER's time to prepare and make decisions, as well as providing NSPs and other stakeholders with sufficient opportunities to make submissions during the process.

A minor reduction will be made to the timeframe so that stakeholders now have 30 business days (instead of 60 business days under the draft rule) after the publication of the issues paper to make a submission on the regulatory proposal and issues paper. This means there will be an overall timeframe of 70 business days for submissions to be made on the regulatory proposal (as opposed to 100 business days under the draft rule). The public forum will also be 10 business days after the issues paper is published (as opposed to 20 business days under the draft rule), while the time between the public forum and close of first round submissions will be 20 business days. Nevertheless, the overall timeframe will still be greater than the existing arrangements.

With respect to the NSPs' proposal to create two separate stages for submissions on the draft regulatory determination, the Commission considers that this is not necessary, given that the cross-submissions stage may be triggered by the AER to address specific issues raised in submissions that it considers further consultation is required.[358] In addition, the AER has the discretion to choose the time by which stakeholders must make a submission on the draft regulatory determination and revised regulatory proposal, which can be after the date when the revised regulatory proposal is submitted.

Instead of the separate steps for submissions, the Commission has decided to align the minimum timeframe for making submissions on the draft regulatory determination with the maximum timeframe for the NSP to submit its revised regulatory proposal.

---

356 ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 17.

357 ENA, Draft Rule Determination submission, 4 October 2012, pp. 66-68; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 6-7.

358 Ibid.

This will mean that, at a minimum, the deadline for submissions on the draft regulatory determination can occur at the same time as the NSP's submission of the revised regulatory proposal (if required) is due; otherwise, the AER can decide to extend the deadline for submissions on the draft regulatory determination to a time after the NSP submits its revised regulatory proposal (if required). Therefore, the proposed 40 business days for submissions on the draft regulatory determination (as specified in the draft rule) will be changed to a minimum of 45 business days. Further, the alignment between the minimum time to make submissions on the draft regulatory determination and the maximum time for NSP's submission of its revised regulatory proposal will now be consistent with the current arrangements.

As a result of these minor amendments to the extended time for the regulatory determination process, the overall timeframe will be four months earlier than the current arrangements (as opposed to six months under the draft rule). An advantage for most NSPs is that their regulatory proposals will not be due between the Christmas and New Year period. Although this may not alleviate some of the concerns from NSPs regarding inaccurate information, the consideration of this reduction has been balanced with the need for allowing the improvements to the overall regulatory determination process. Therefore, the NSP will need to submit its regulatory proposal to the AER at least 17 months, instead of 13 months, before the end of the current regulatory period.

Completion of the regulatory determination process

In terms of the NSPs' proposal for the regulatory determination process to be completed earlier to reduce the burden related to the pricing proposal process, the Commission notes that this is outside the scope of this rule change process.[359] As noted in the IPART submission, a separate rule change request has been submitted on the annual pricing proposal framework.[360] The Commission's Power of Choice review has also made a draft recommendation to allow sufficient time in the current annual tariff setting process for the AER to monitor DNSPs with respect to actively developing and improving their tariff structures to meet revised pricing principles as best as possible at all times.[361] Therefore, the final position rule will not address the issues associated with completing the regulatory determination process earlier. That said, the arrangements will be flexible in the sense that the final regulatory determination will be required to be completed no later than two months before the end of the regulatory control period, which will allow the AER the discretion to complete the final regulatory determination before that time.

Cross-submissions stage

The Commission notes the NSPs' concern with giving the AER discretion to trigger the cross-submissions stage with the view that this step should be mandatory and limited in scope.[362] In developing the cross-submissions stage, the Commission took into

359 ENA, Draft Rule Determination submission, 4 October 2012, p. 68.

360 IPART, Draft Rule Determination submission, 2 October 2012, pp. 1, 4-5.

361 AEMC, *Power of choice - giving consumers options in the way they use electricity*, Draft Report, 6 September 2012, p. 109.

362 ENA, Draft Rule Determination submission, 4 October 2012, p. 67; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 30-31.

account the New Zealand Commerce Commission's approach, which NSPs originally relied on as the basis for their proposal. The Commission considers that the reason the cross-submissions stage has been implemented with great effect in New Zealand is that it is at the discretion of the regulator to trigger that stage and the scope of it is limited according to the submissions provided from stakeholders.

Further, if the stage was mandatory, this could create another opportunity for NSPs to make late submissions. NSPs consider that this could be discouraged by limiting the scope of submissions as well as the AER's reporting of late or out-of-scope submissions.[363] However, the Commission considers that making it a discretionary stage and limiting the scope are complementary tools which the AER can use to implement the cross-submissions stage.

The NSPs' concern that the AER may not be able to fully understand or identify the relevant significant issues can be alleviated in other ways which does not necessitate prescription of a more lenient cross-submissions stage.[364] The Commission has stated that the regulatory determination process should be considered as a minimum standard to which the AER and NSPs can engage in the process. Outside of this, NSPs and the AER should be engaging with each other informally. The need for the AER to understand the NSPs' concern as to its significant issues can therefore be addressed by informal communication between the NSP and the AER. A formal cross-submissions stage should not be seen as a substitute for good regulatory practice, including dealing with procedural fairness issues, for all of the parties involved.

Submission guidelines

As a general rule, the Commission has taken the view that where there is no substantive reason for any difference in the regulation between transmission and distribution, then there should be an alignment between the two. In examining the differences between the submission guidelines and the later arrangements under Chapter 6 which incorporate the RIN, the Commission considers that the arrangements can be better aligned. The Commission considers that applying two different instruments to achieve the same purpose is administratively inefficient and has therefore decided that it should be aligned in the form of the RIN with consequential changes to the NER. The TNSPs' objections to replacing submission guidelines with the RIN for reasons of administrative costs and lack of benefit of alignment are outweighed by the long term benefit to customers in having a consistent regime in which the AER can regulate in a consistent manner and other stakeholders can be better engaged by following a consistent regulatory determination process.[365]

8.4.2 Confidentiality claims in the regulatory proposal

The Commission notes Origin's particular issue that the confidentiality claims will not be reduced through the draft rule.[366] As previously stated, the Commission considers that the AER currently has sufficient authority under the NEL and common law to

363 Ibid.

364 Ibid.

365 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14.

366 Origin, Draft Rule Determination submission, 4 October 2012, p. 2.

address confidentiality claims made in regulatory proposals. The draft rule was not intended to displace those arrangements. However, additional tools will be provided to the AER in the form of confidentiality guidelines. These will include: the AER to specify the manner in which confidentiality claims to be made by NSPs in their regulatory proposals; the need for the NSP to identify their confidentiality claims; and the AER to report on confidentiality claims on its website. Together, these provide additional incentives for NSPs to be more accountable in providing genuine confidentiality claims and the AER with some tools additional to its existing powers under the NEL and common law in addressing confidentiality claims.

The Consumer Action Law Centre also claims more can be done with respect to confidentiality claims by requiring confidentiality protocols to be put in place by the NSP.[367] However, as the Commission stated in its draft rule determination, this is unnecessary as the NSPs and the AER could be doing this as part of its stakeholder engagement plan without the need for prescription in the NER.

8.4.3 Framework and approach

Need for the framework and approach stage

With respect to the approach in the draft rule determination which provided the AER with the sole responsibility to trigger the framework and approach stage and not the NSP, the Commission recognises the NSPs may be in a better position at times to understand whether there should be a need for any new components or changes to existing components in the framework and approach paper. For this reason, the Commission accepts the NSPs' submission to also be able to trigger the framework and approach stage.[368] This means that the NSP will need to advise the AER on whether it considers there is a need for the stage and that the NSP can trigger the stage. The difference between the steps for the AER to trigger the process compared to NSPs is that the NSP will only be required to notify the AER by a certain date, while the AER will still be required to consult on particular components not triggered by the NSP. The AER should take into account the interests of third parties such as consumers in deciding whether it will trigger the framework and approach stage.

Introduction into transmission

With respect to TNSPs' objection to the introduction of the framework and approach stage into transmission, the Commission will be applying the same position as it has for distribution.[369] For transmission, new incentive schemes and information requirements for forecast expenditure assessments will now be addressed, which will be covered in the framework and approach stage.[370] The advantage of having a framework and approach paper for transmission is that it encourages engagement earlier in the process, especially with third parties such as consumer representatives, and therefore reduces the amount of information to be considered later in the regulatory determination process. As a result, it should increase administrative efficiency in the process. Further,

367 Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4.

368 ENA, Draft Rule Determination submission, 4 October 2012, pp. 8, 73-74.

369 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12-13.

370 NSPs will also be required to advise the AER of their approach to expenditure forecasting.

as stated earlier, where there is no substantive reason for any difference in the regulation between transmission and distribution, then there should be an alignment between the two.

Threshold for changing service classification and formulaic expression of the control mechanism in regulatory determinations

The Commission notes the ENA's examples where it considers the unforeseen circumstances test to be inappropriate eg, where development of competition may be foreseeable at the time but its impact on the market is unknown, and where a contingent project trigger event occurs which would require alteration of the service classification.[371] With the former example, if development of competition may be foreseeable at the time but its impact on the market is unknown, the impact on the market can still be regarded as unforeseeable. Otherwise if the impact on the market was foreseeable, then appropriate service classification should have been made during the framework and approach stage.

Likewise, the contingent project may be foreseeable at the time although its scope and cost is unknown, but the change in service classification can still be regarded as unforeseeable. Otherwise if the change in service classification was foreseeable, then appropriate service classification should have been made during the framework and approach stage.

For both of the above examples, the Commission notes that the AER has the responsibility to consider whether a change in circumstances was foreseeable or unforeseeable. The Commission maintains the view that the unforeseen circumstances test is adequate.

8.5 Guidance on final position rule

8.5.1 Late or out-of-scope submissions

If the AER receives a late or out-of-scope submission from a NSP, the AER is required to make available on its website the following information:

- the identity of the NSP who made the late or out-of-scope submission;
- a summary of the particular information it considers to be late or out-of-scope;[372] and
- an indication of the amount or length of that information that it considers to be late or out-of-scope.

In addition to the above, the NSP may wish to informally respond to the AER to explain its reasons for providing such a submission once it is made aware of the AER's position.

371 ENA, Draft Rule Determination submission, 4 October 2012, pp. 74-75.

372 For instance, the summary may simply cross refer to that information as contained in the submission.

8.5.2 Confidentiality claims in the regulatory proposal

As noted earlier, to promote adherence to a process for addressing confidentiality claims, the final position rule requires the AER to issue guidelines. These guidelines will regulate the manner in which the NSP makes confidentiality claims in its regulatory proposal, which may include identifying relevant categories of confidential information. The guidelines are consulted upon in accordance with the standard consultation procedures for guidelines in the NER. The NSP and other stakeholders then have an opportunity to clarify the requirements for making confidentiality claims in regulatory proposals.

Once the guidelines are in place, the NSP is required to identify to the AER which information it claims to be confidential. This may include identifying the category of confidentiality claim that the NSP wishes to make. Based upon this information, the AER is able to determine the comparative proportion of material that has been claimed as confidential with regard to other NSPs. The AER can then report on its website that a confidentiality claim has been made. Other information on the website include:

- the identification of the NSP;
- the quantity and proportion of confidential information; and
- a comparison of the NSP's proportion of confidential information to other NSPs.

The AER will not be required to report on other more specific aspects such as categories of confidentiality claims. That type of information is more for the AER's benefit when addressing confidentiality claims.

As an example, the AER provided a table in a previous submission to demonstrate the proportion of material from NSPs that it has previously received claiming to be confidential.[373] This is reproduced and shown in Table 8.1. The AER could use a similar format on its website to report on confidentiality claims and include the identification of the NSP and proportion of confidential information claimed from each NSP.

Table 8.1 Page count - documents submitted by DNSPs in the AER's Victorian electricity distribution determination (2011-15)

	Regulatory proposal		Revised regulatory proposal	
	Public	Confidential	Public	Confidential
Business 1	1,540	4,584	4,157	5,599
Business 2	2,960	5,231	9,337	10,235
Business 3	1,869	22,811	1,704	2,626

Source: AER, Directions Paper submission, 2 May 2012, p. 71.

In addition to the rule for confidentiality claims with respect to initial or revised regulatory proposals, the Commission considers that the same rules could also be

373 AER, Directions Paper submission, 2 May 2012, p. 71.

applied to the pricing methodologies and to submissions in general.[374] However, no consequential amendments will be made to the NER to align confidentiality claims in respect of submissions with the Commission's position on regulatory proposals. This is because NER provisions relating to confidentiality claims in submissions already exist. Conversely, the Commission considers it appropriate to treat confidentiality claims in respect of pricing methodologies for transmission consistently with confidentiality claims in respect of regulatory proposals.

8.5.3 Mandatory issues paper and overview paper

Issues paper

The Commission has decided to require the AER to publish an issues paper. The purpose of the paper is to identify the preliminary issues that the AER considers are likely to be relevant to its assessment of the NSP's regulatory proposal. However, the AER is not precluded from considering other issues when making its regulatory determination. Therefore, the issues paper is not an exhaustive review of the proposal and does not contain a complete list of the matters that the regulator would consider in making its final regulatory determination.

The issues paper is published within 40 business days of the AER receiving the NSP's regulatory proposal. It is noted that the publication date for the issues paper is not based on when a resubmitted regulatory proposal, if required to be resubmitted, is received by the AER. This is because the AER can still prepare the issues paper while it waits on further information to be included in the resubmitted regulatory proposal. Therefore, only the period between the resubmitted regulatory proposal and issues paper is affected. Besides the public forum on the issues paper, the other milestones in the regulatory determination process are not contingent on the date that the issues paper is published.

The deadline for submissions on the issues paper and regulatory proposal is required to be no earlier than 30 business days after the AER publishes its issues paper. This means that the deadline for submissions on the regulatory proposal is essentially no earlier than 70 business days after receipt of the regulatory proposal.[375] The additional time for submissions on the regulatory proposal takes into account the introduction of the issues paper and submissions associated with that paper.

Submissions on the issues paper are due at the same time that submissions on the regulatory proposal are due. This reflects the purpose of the issues paper, which is to assist stakeholders, particularly consumers and consumer representative groups, in preparing their submissions on the regulatory proposal.

Overview paper

With a consumer-specific focus in mind, the mandatory overview paper needs to explain how the NSP has engaged with electricity consumers in preparing its regulatory proposal. The paper also provides a summary of the regulatory proposal for electricity

---

374 Pricing methodologies are submitted with the regulatory proposal in transmission.

375 This time also takes into account the 40 business days for the AER to publish its issues paper after receipt of the regulatory proposal.

consumers. In this way, the overview paper acts as a "map" to the regulatory proposal and helps consumers focus on the relevant parts when responding to the regulatory proposal. In addition, the paper will explain how the NSP has sought to address any relevant concerns identified as a result of the engagement with electricity consumers. To further focus the attention of consumers, the paper will describe the key risks and benefits of the regulatory proposal for electricity consumers. Finally, the paper will compare the total revenue approved for the current regulatory period with the NSP's proposed total revenue for the next regulatory period. In this regard, the NSP is to provide an explanation for any material differences between these two amounts.

Given that consumers need to be able to easily access the paper, the overview paper is a standalone document provided with the regulatory proposal. This means that the paper is to be in plain language, that is, it must not use technical language or industry jargon.

To reflect the overview paper's importance in the process, the AER will be given the ability to accept or reject the overview paper which accompanies the regulatory proposal. If the AER considers that the overview paper does not comply with the NER requirements, the AER may reject the overview paper and require that this paper be resubmitted, addressing any relevant requirements. To provide clarity to the NSP on the information required in the overview paper, the AER can utilise a regulatory information instrument.

Public forum

The AER will be required to convene a public forum on the NSP's regulatory proposal and the AER's issues paper. This must be held within 10 business days after the AER publishes its issues paper on the NSP's regulatory proposal.

8.5.4 Cross-submissions stage

The final position rule provides for a cross-submissions stage in the NER. The AER will have the discretion to decide whether or not the cross-submissions stage is required immediately following the close of submissions on the revised regulatory proposal. If the AER does not invite submissions on the revised regulatory proposal, it implies that the cross-submissions stage is unnecessary. The AER will have the discretion to limit the scope of the cross-submissions stage. The scope is limited to specified matters that have been raised during submissions on the draft regulatory determination or submissions on the revised regulatory proposal. If utilised, the cross-submissions stage allows for at least 15 business days for submissions after the invitation for submissions is published.

8.5.5 Timing of the regulatory determination process

Commencing the regulatory determination process four months earlier, as can be seen in Figure 8.3, will allow for:

- the AER to prepare and publish the issues paper within 40 business days following receipt of the NSP's regulatory proposal;
- stakeholders to submit on the issues paper and regulatory proposal no earlier than 30 business days following the publication of the issues paper;

- a public forum to be held within 10 business days after publication of the issues paper;
- the NSP to submit its revised regulatory proposal within 45 business days after the publication of the draft regulatory determination;
- other stakeholders to submit on the draft regulatory determination no earlier than 45 business days after the publication of the draft regulatory determination; and
- a cross-submissions consultation stage of no earlier than 15 business days.

Figure 8.1 and Figure 8.2 are examples of the current regulatory determination process applicable to TNSPs and DNSPs, while Figure 8.3 shows the changed process according to this final position paper.

Figure 8.1 Example of the current regulatory determination process applicable to TNSPs (hypothetical dates used)

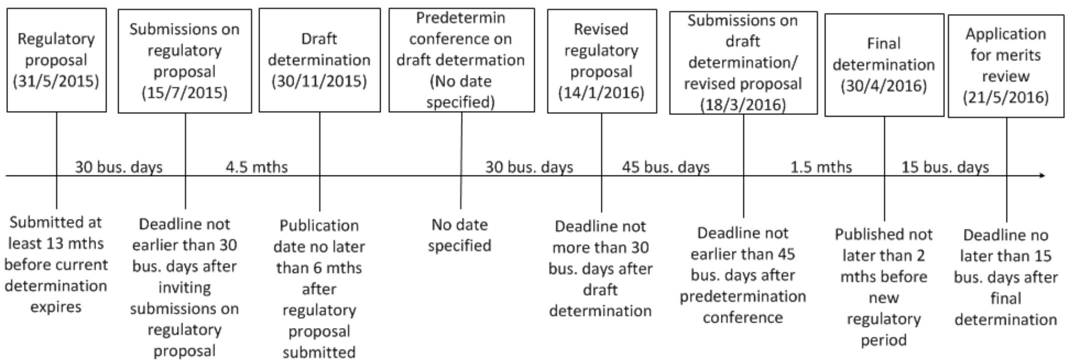
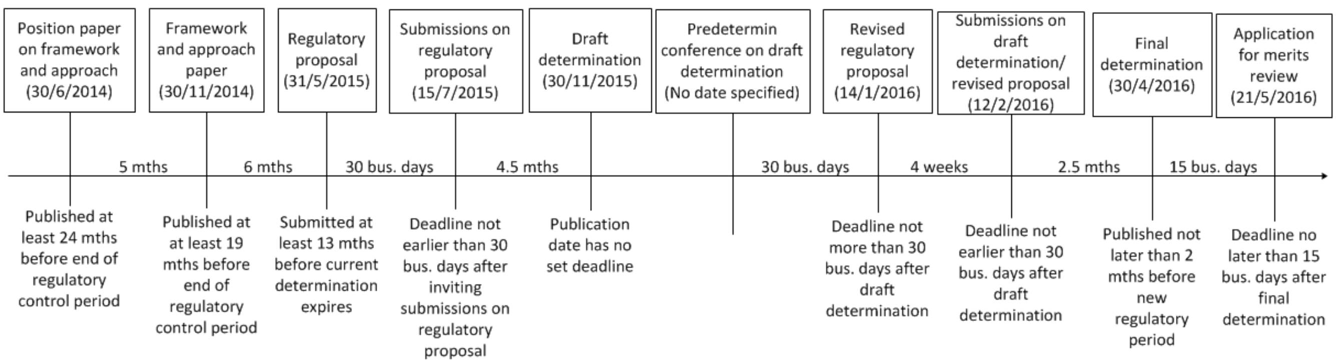
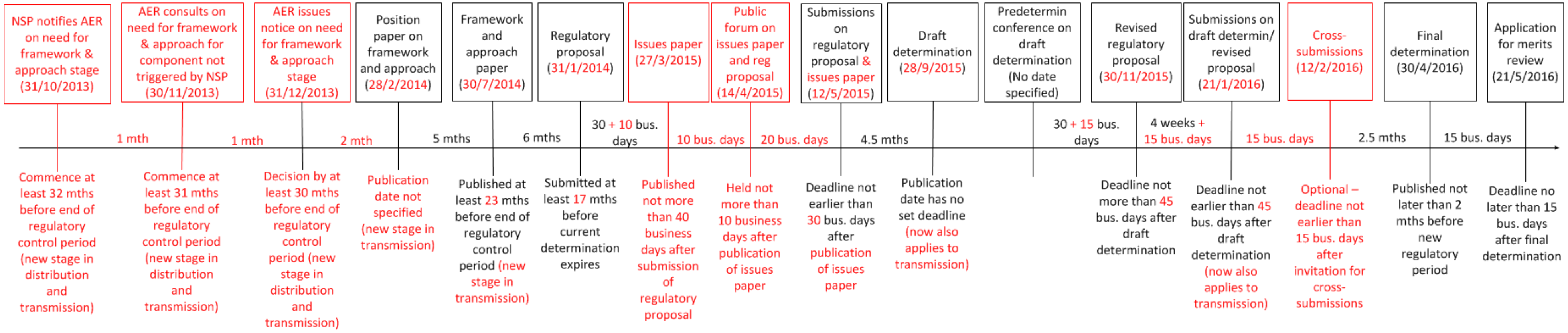


Figure 8.2 Example of the current regulatory determination process applicable to DNSPs (hypothetical dates used)



Note: the dates used in Figure 8.1 and Figure 8.2 are hypothetical and are only used to illustrate the differences between the existing timeframe in these figures and the new timeframe shown in Figure 8.3.

Figure 8.3 Example of the new regulatory determination process applicable to DNSPs and TNSPs (hypothetical dates used)



Note: the dates used in Figure 8.3 are hypothetical; changes to the current regulatory determination process are highlighted in red text.

8.5.6 Framework and approach paper

Triggering the framework and approach paper

The AER or the NSP will have the discretion to trigger the framework and approach paper stage. The circumstances in which the framework and approach stage is required are if:

- there is no previous framework and approach paper on a particular component or components; or
- the AER or NSP decide that a particular component or components from the previous framework and approach paper will be amended or replaced.

The circumstances above require that there must always be in place a framework and approach paper on a particular component or components, even if that is a previously existing framework and approach paper. A corollary of this is that, where a framework and approach paper on a particular component has previously been put in place, the requirement for a framework and approach paper on that particular component or components can be bypassed if the existing framework and approach for that component or components is still appropriate. In other words, the framework and approach paper can only be reopened for the particular components that the AER or the NSP decides should be consulted upon.

Where the AER is considering whether to trigger the framework and approach stage on a particular component or components, the AER has the responsibility to consider all stakeholder comments on whether a revised framework and approach paper is necessary to address a particular component or components. This is done prior to the AER making a decision on whether to trigger the framework and approach paper stage. This gives relevant stakeholders an opportunity to make a submission to the AER. It also promotes transparency in the process. Alternatively, the AER may not receive any submissions on triggering a framework and approach paper on a particular component or the NSP may not trigger a framework and approach paper on a particular component or components, but the AER can still decide to trigger the stage.

To this end, if the AER is deciding whether to trigger the framework and approach stage on a particular component or components, then the AER must:

1. issue an invitation for comment by at least 31 months before the end of the current regulatory period;
2. issue a notice on whether it will trigger the framework and approach stage by at least 30 months before the end of the current regulatory period;
3. then commence consultation on the framework and approach paper on that particular component or components; and
4. have completed and published the framework and approach paper by at least 23 months prior to the end of the current regulatory period.

Alternatively, if the NSP decides to trigger the framework and approach stage on a particular component or components:

1. the NSP is required to notify the AER at least 32 months before the end of the current regulatory period on which particular component or components that should be triggered in the framework and approach stage;
2. the AER must issue an invitation for comment on other components that are not covered by the NSP request by at least 31 months before the end of the current regulatory period;
3. the AER must issue a notice on the NSP's requested components to be considered in the framework and approach stage and whether there are any other particular components that the AER considers is to be considered in the framework and approach stage by at least 30 months before the end of the current regulatory period;
4. the AER must then commence consultation on the framework and approach paper on that particular component or components; and
5. the AER must have completed and published the framework and approach paper by at least 23 months prior to the end of the current regulatory period.

Unlike the steps for the AER to consider whether to trigger the stage, if the NSP triggers the stage on a particular component or components, then the AER is not required to consult with stakeholders on whether to trigger the stage on that particular component or components. In such a scenario, the reason that the NSP will be required to notify the AER at least 32 months before the end of the current regulatory period is to give the AER enough notice so it avoids unnecessarily consulting with other stakeholders on whether to trigger the stage on that particular component or components, which would have occurred one month later but for the NSP triggering the stage. The NSP is to provide reasons to the AER for triggering the stage to assist the AER and other stakeholders when they consider whether other components should be triggered that the NSP had not triggered. Notwithstanding the above, the AER is still required to consult on other components that the NSP does not trigger.

As there must be a framework and approach paper in respect of dual function assets, it is necessary for the determination on the price regulation of dual function assets to be brought forward to be aligned with the framework and approach paper process. To give the AER enough notice, the AER is advised of the value of the relevant dual function assets before it commences consultation on whether to initiate a framework and approach paper. This means that the AER is advised on this value at least 32 months prior to the end of the current regulatory control period. Given that the value ascribed to the relevant dual function assets must correspond to an opening value for a regulatory year, the time as at which this value must be determined needs to be 36 months prior to the end of the current regulatory period.

Threshold for departing from a component in the framework and approach paper

The AER will be able to depart from the framework and approach paper in respect of the components covered by it during the regulatory determination process. For example, service classifications and the formulaic expression of the control mechanisms can depart from the framework and approach paper for unforeseen circumstances. Another example is the AER can depart from the relevant framework and approach paper for the application of incentive schemes during the regulatory determination stage, although it must give reasons for doing so. However, the form of the control mechanism and the pricing of services provided by dual function assets continue to be set as in the framework and approach paper.

An example of how the "unforeseen circumstance" threshold could be applied may be with respect to a pending judicial decision where a service classification is contingent on that decision. Here, the pending judicial decision is one event and the actual judicial decision is another event. Although it may be argued that the pending judicial decision is foreseeable, the actual judicial decision could probably not be reasonably foreseen until the decision has been made. The service classification would have to be based on what is known at the time the framework and approach paper is made, but could be departed from once the actual judicial decision is made. On the other hand, if the judicial decision was foreseeable at the time of the framework and approach stage, then the service classification should have been classified at that stage and it would not be appropriate to depart from this at a later stage as it was foreseeable. Nevertheless, the AER has the responsibility to consider whether a change in circumstances was foreseeable or unforeseeable.

9 Diverse issues

Summary

- The capex reopener and contingent project mechanisms will be introduced in Chapter 6 of the NER (distribution) to allow for efficient costs to be recovered for unexpected events. The contingent project threshold will be set to the greater of $30 million or five per cent of the ARR or MAR for transmission and distribution. A materiality threshold of one per cent of the annual revenue requirement (ARR) will apply to cost pass through applications in distribution. These changes will bring the uncertainty regime for distribution into line with transmission.
- The AER's decision-making timeframe for applications made under the uncertainty regime will be aligned between distribution and transmission. Some flexibility will be given in the timeframe to account for complex or difficult issues, and waiting on information from certain third parties. This will provide the appropriate balance between certainty and finality with flexibility in the process.
- The AER's power to revoke and substitute a decision for a material error or deficiency under Chapter 6A will be limited to "computational" errors by the AER or false or misleading information provided to the AER by another party. This will bring into line the AER's power with Chapter 6, as well as providing for finality and certainty in the process.
- The AER will be given the power to establish the shared assets cost adjustment mechanism. This will apply to assets which provide standard control services or prescribed transmission services as well as unregulated services. The shared assets cost adjustment mechanism will be designed in accordance with specific principles and guidelines. This will allow for innovation by NSPs and cost reflectivity for customers of standard control services or prescribed transmission services.
- Balancing the promotion of innovation and flexibility in regulation with good regulatory practice, the AER will be able to develop small scale pilot or test incentive schemes. This will allow the potential impact of such an incentive scheme to be understood before full implementation.

Difference between draft rule and final position rule

- In the draft rule, the contingent project thresholds were to be linked to the greater of five per cent of the MAR or ARR and the RIT-T, as varied, for transmission and the proposed RIT-D, as varied, for distribution. In the final position rule, the distribution and transmission contingent project thresholds will now be based on the greater of $30 million or five per cent of the ARR or MAR, respectively.
- In the draft rule, the shared assets cost adjustment mechanism was to only apply to a shared asset providing both standard control services and alternative control services or unregulated services in distribution, and both

prescribed transmission services and unregulated services in transmission. The final position rule now limits the mechanism to a shared asset providing both standard control services and unregulated services in distribution, and both prescribed transmission services and unregulated services in transmission.

9.1 Introduction

The AER raised in its rule change request certain diverse issues. These related to:

- the appropriateness of applying particular uncertainty regime mechanisms in distribution and aligning decision-making timeframes for the uncertainty regime mechanisms;
- when the AER can revoke and substitute regulatory determinations to address material errors;
- how shared assets should be regulated; and
- the development of small scale incentive schemes.

9.1.1 Uncertainty regime

Like most businesses, a NSP operates in an uncertain environment.[376] Uncontrollable external events can alter the quantity and nature of services required to be provided.[377] In a normal competitive environment, production and pricing behaviour would adjust to respond to these changes where efficient producers can recover their costs and should generally earn at least a normal return on their investments.[378] The regulatory arrangements, including the uncertainty regime, attempt to mimic the competitive market by allowing the NSP to alter its production behaviour to meet market demand and undertake unexpected investment in new network capacity.[379]

For the purposes of this final position paper, the "uncertainty regime" under the NER comprises contingent projects, capex reopeners and pass through events. These mechanisms deal with expenditure that is required to be undertaken during a regulatory period but which is not able to be predicted with reasonable certainty at the time of preparing or submitting a regulatory proposal to the AER for the start of the next regulatory period. A more accessible uncertainty regime will, on the one hand, facilitate certain capex or opex projects being undertaken, though on the other hand it may reduce the incentive to undertake only efficient capex and opex in some circumstances. An appropriate uncertainty regime will contribute to efficiency of investment by allocating risks to the party best able to deal with them, including appropriately sharing the risks of external events.

376 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 54.

377 Ibid.

378 Ibid.

379 Ibid.

Capex reopeners and contingent projects

Contingent projects and capex reopeners are not currently included under Chapter 6 for distribution. This was because the MCE Standing Committee of Officials (SCO) considered when developing Chapter 6 that distribution projects were different to transmission with respect to their nature and profile of capex, with uncertainty around certain capex projects to be dealt with via pass through provisions, and the objective that this would strike a reasonable balance between not penalising the DNSP for events outside its control and ensuring appropriate operation of the incentives regime within the regulatory framework.[380]

The AER proposed to include capex reopener and contingent project provisions in Chapter 6 of the NER.[381] In general, these would operate in distribution in the same way as they currently operate in transmission in Chapter 6A. Associated with this is setting an appropriate threshold; and the AER proposed using the same value as in transmission for capex reopeners and contingent projects, with the AER being able to vary the contingent project threshold values through the use of guidelines.

In respect of cost pass through events, the AER proposed a materiality threshold of one per cent of the ARR to apply to distribution.[382]

The AER also proposed that, where as a result of a cost pass through application the AER allows capex which is fully recovered during the regulatory period in which the relevant event occurs, the capex should not be rolled forward into the RAB at the next regulatory determination.

Timeframes for AER decision-making under the uncertainty regime

When the AER receives an application for cost pass throughs, contingency projects or capex reopeners, it has a set time to make its decision which varies according to the type of application.[383] The AER proposed for it to have more time to consider complex applications, which would involve an aligned timeframe set at 40 business days for normal applications with the ability to extend by an additional 60 business days for more complex or difficult applications.[384]

9.1.2 Material errors

The NER allow the AER to revoke and substitute regulatory determinations where a material error arises. Depending on whether it is a distribution or transmission regulatory determination, there are different types of material errors which allow for revocation and substitution of regulatory determinations.

The AER was concerned that there may be the potential for a material error that would be outside the currently prescribed list for distribution regulatory determinations.[385] In

380 MCE SCO, *Response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing*, 1 August 2007, pp. 29, 48.

381 AER, Rule change request, Part B, 29 September 2011, pp. 46-52.

382 Id., p. 50.

383 An exception to this is for negative pass throughs which have no set time limit.

384 AER, Rule change request, Part B, 29 September 2011, pp. 99-100.

385 Id., pp. 95-96.

transmission, uncertainty is created by the power to correct material errors caused by false or misleading information provided by the TNSP as there is no express limit placed on correcting such errors only to the extent necessary.[386] There may also be circumstances in which it may be more preferable or appropriate to amend a regulatory determination, as opposed to revoking and substituting the entire regulatory determination.[387]

The AER sought to remove these differences by broadening its ability to revoke and substitute for material errors in Chapter 6 of the NER. This would entail replacing the prescribed list of material errors in Chapter 6 with a more general reference to material errors or deficiencies, limiting changes related to false and misleading information under Chapter 6A "only to the extent necessary", expanding the circumstances for revoking and substituting regulatory determinations to address deficiencies under Chapter 6A, and being able to amend regulatory determinations in response to material errors.[388]

9.1.3 Shared assets

In this final position paper, shared assets refer to assets used to provide both standard control services or prescribed transmission services and unregulated services. For distribution, the shared asset could be providing a combination of standard control services and unregulated services. For transmission, the shared asset could be providing both prescribed transmission services and unregulated services. This issue is likely to become more relevant in light of the potential for electricity network assets, such as poles and pits, to be used to provide access for the National Broadband Network (NBN).

The AER proposed shared assets cost adjustment mechanisms to allow consumers to benefit where distribution assets are used to provide non-standard control services, including alternative control services and unregulated services.[389] This could include an ex ante forecast revenue adjustment to the ARR, or an ex post control mechanism adjustment such as reflecting the portion of revenue from the unregulated service.

9.1.4 Small scale incentive schemes

The AER proposed that it should have the power to develop incentive schemes outside of those already provided for in the NER.[390] It considered the rule change process for implementing new incentive schemes was cumbersome and over costly. The AER also proposed to amend Chapter 6A of the NER such that it would have discretion to decide

386 Ibid.

387 Ibid.

388 False and misleading information is already limited in Chapter 6 in this way. "Deficiency" is already included in Chapter 6. For further information, see AER, Rule change request, Part B, 29 September 2011, p. 96.

389 AER, Rule change request, Part B, 29 September 2011, p. 60.

390 Id., pp. 56-58.

whether or not to apply the existing incentive schemes to NSPs at the time of the regulatory determination.[391]

9.1.5 Chapter structure

The remainder of this chapter is structured as follows:

- section 9.2 summarises the Commission's position in the directions paper and draft rule determination;
- section 9.3 summarises the submissions received in response to the Commission's draft rule determination;
- section 9.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- section 9.5 provides guidance on the final position rule.

9.2 Directions paper and draft rule determination

9.2.1 Uncertainty regime

Need for capex reopeners and contingent projects in distribution

In the directions paper, the Commission decided to include contingent projects and capex reopener mechanisms for distribution. This would better harmonise transmission and distribution, as well as making the NSP more accountable rather than relying on cost pass through applications for uncertain circumstances. A range of reasons were given for why the TNSP and DNSP face similar levels of uncertainty. Unlike competitive businesses, which are better able to adjust their behaviour in response to uncontrollable factors, the TNSP and DNSP are both generally obliged to continue to supply services even where their equipment is exposed to significant risks. In the absence of an uncertainty regime, the added risk for a regulated business would be factored into the cost of capital, forcing it up. A regulated business might also have more of an incentive to increase the forecast of capex or opex in its regulatory proposal to factor in circumstances which it cannot predict.

In the draft rule determination, the Commission elaborated further on its position in the directions paper. The Commission's starting point was that Chapters 6 and 6A of the NER should be consistent unless there are substantive reasons for a difference. The Commission accepted that there are certain disadvantages of an expanded uncertainty regime. It could dampen the incentive effects of an ex ante allowance in certain circumstances. It could also create administrative burden for the AER and stakeholders in responding to "mini-determinations" during the regulatory period. On balance, however, the Commission decided to maintain its position from the directions paper.

By setting the thresholds for these mechanisms at the correct level, as further discussed below, only the largest projects or events, which could be expected to have longer lead times, would be captured. Accordingly the administrative burden on stakeholders would be limited. In addition, experience with the uncertainty regime in Chapter 6A

391 Id., p. 57.

indicates that the incentive effects of the ex ante allowance provided under the regulatory determination process would not be substantially weakened.[392]

In respect of whether pass throughs provide sufficient protection, capex reopeners are intended to fulfil a different function by extending protection to very large events which are more difficult to predict and are more difficult to fully provide for as cost pass through events. Contingent projects, on the other hand, apply to a matter which is more specific to a particular business and more likely to occur than a cost pass through.

Stakeholders had previously expressed concerns with expanding the uncertainty regime for distribution. These related to the potential increase in intra-period determinations, administrative burden placed on parties to participate in each application, and weakening the expenditure discipline and price/revenue cap regime.[393] Some suggested that a NSP should be using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the uncertainty regime mechanisms.[394] In general, the Commission would expect a NSP to act in this way in respect of smaller projects. The threshold for capex reopeners and contingent projects means that these can only be used for larger projects. For such projects, it will be more difficult for the NSP to accommodate these within the existing allowance.

NSPs also suggested that the current uncertainty regime for transmission is not effective.[395] However, the Commission was of the view that it would be outside the scope of this rule making process to review the effectiveness of the uncertainty regime for transmission. Issues specifically associated with the effectiveness of the cost pass through regime have been addressed as part of another rule change process.

Threshold for capex reopener and contingent project applications in distribution

For contingent projects, the AER proposed a threshold of $10 million which it considered was consistent with the AEMC's original intention in 2006 to align this with the regulatory test threshold.[396] In the draft rule determination, the Commission noted that there were mixed responses from DNSPs suggesting either the contingent project threshold was too low or too high.[397] The Commission maintained its position from 2006 and considered that the threshold should be aligned to the regulatory test threshold ie the Regulatory Investment Test for Transmission (RIT-T) and the proposed Regulatory Investment Test for Distribution (RIT-D). For this reason, guidelines were considered unnecessary to vary the contingent project threshold or for the contingent

392 It is noted that under Chapter 6A, these mechanisms have not so far created a significant burden, given that the contingent project mechanism has been used twice while capex reopeners have never been used.

393 Ethnic Communities' Council of NSW, Directions Paper submission, 16 April 2012, p. 3; EUAA, Directions Paper submission, 16 April 2012, pp. 24, 26.

394 MEU, Directions Paper submission, 17 April 2012, pp. 47-48, 60.

395 ENA, Directions Paper submission, 16 April 2012, pp. 27-28, 34-35.

396 The regulatory test threshold in transmission has now been superseded by the RIT-T.

397 Ausgrid, Directions Paper submission, 16 April 2012, p. 7; SP AusNet, Directions Paper submission, 16 April 2012, p. 5.

project threshold to be indexed by inflation.[398] Instead, the contingent project threshold would be directly linked to the estimated capital cost of the most expensive option to address the identified need under the RIT-T, as varied, for transmission and the proposed RIT-D, as varied, for distribution.[399]

Materiality threshold for cost pass through applications in distribution

The AEMC considered in 2006 the materiality threshold for cost pass through applications in transmission as important to promote stability and predictability of the revenue cap regime for both the regulator and the NSP.[400] Without such a threshold, it was considered that this would lead to greater uncertainty and an increase in administrative costs for the AER to determine a material event.[401] Hence, it was determined that the threshold should be one per cent of the maximum allowed revenue (MAR) for transmission.

In response to the AER's rule change request, some DNSPs proposed that the materiality threshold for distribution should not be set as a value in the NER.[402] Instead, they considered that it should remain flexible to capture all non-trivial matters and reflect less lumpy capex in distribution.[403] Otherwise, the DNSP would be exposed to unrecoverable risks.[404] However, in the draft rule determination, the Commission was of the view that such an approach would introduce an undesirable degree of subjectivity into cost pass through determinations, and give the DNSPs too much of an avenue to submit applications, which may or may not be trivial in nature. On balance, the Commission considered that a materiality threshold needed to be specified to provide for greater certainty to both the regulator and the DNSP.

The Commission understood that the AER applied the one per cent threshold in practice for distribution, even though it is prescribed only for transmission. Therefore, there should not be a significant impact on DNSPs in codifying existing AER practices, and no reason for a difference between transmission and distribution. This would provide for consistency, transparency, predictability and certainty on when the AER would be required to consider cost pass through applications.

Double recovery of capex arising from cost pass through applications

In its rule change request, the AER raised the issue that there would be a potential double recovery of capital costs through both cost pass through applications and including that incurred capex again when establishing the roll-forward RAB for the next regulatory period. In the directions paper and draft rule determination, the Commission supported this proposal to avoid the potential unintended double

398 Victorian DPI, Consultation Paper submission, 8 December 2011, pp. 5, 8.

399 In distribution, this value is equivalent to the estimated capital cost to the NSP affected by the RIT-D project of the most expensive potential credible option to address the identified need of $5 million. In transmission, this value is equivalent to the estimated capital cost of the most expensive option to address the identified need which is technically and economically feasible of $5 million.

400 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 106.

401 Ibid.

402 Ausgrid, Consultation Paper submission, 8 December 2011, pp. 30-32.

403 Ibid.

404 Ibid.

counting. This would be done by excluding the capital costs recovered through approved cost pass through applications during the current regulatory period from the calculation of the roll-forward RAB for the next regulatory period.

Timeframes for AER decision-making under the uncertainty regime

In the directions paper, the Commission considered extending the timeframe for decision-making on cost pass throughs and capex reopeners, but not in respect of contingent projects. In the draft rule determination, this was extended to contingent projects, given the AER's new evidence of the detail and complexity that may be involved in the AER's assessment of contingent project applications.[405]

In the directions paper, the Commission also considered a number of options relating to the circumstances in which the AER may extend its decision-making time and the extent of time required. In developing a position in the draft rule determination, the Commission considered that sufficient certainty and finality must be taken into account. To a certain extent, the need for fixing the timeframe would promote certainty and finality; however, it would not necessarily allow the NSP the ability to recover efficient costs for unforeseen events if there is a substantial delay that is outside of the NSP's control. For this reason, the Commission supported the AER's suggested principle in the draft rule determination that the "stop the clock" mechanism should apply in those circumstances which are outside of the AER or NSP's control. Such circumstances would be where the AER is waiting on the provision of information by a governmental authority, or is waiting on a judicial body or royal commission to make relevant information publicly available.

With respect to the time taken for the AER to wait on additional information from the NSP, the default decision-making time of 40 business days would be subject to the later of the date that the AER receives the NSP's information or any additional information associated with the NSP's written application. This requirement for the NSP to provide the AER with additional information the AER requires to make a determination under the uncertainty regime is currently unique for negative cost pass throughs, and extended to positive cost pass throughs, capex reopeners and contingent projects in the draft rule determination. This way, it was unnecessary to apply an extended decision-making timeframe to circumstances where the AER is waiting for additional information from the NSP.

Where the issues being considered are complex or difficult, but the AER has all the information that it needs, then the AER should be able to determine the issues within a set timeframe, albeit perhaps an extended timeframe. The Commission considered that the AER's proposal for an extended timeframe in these circumstances would provide the appropriate balance between giving the AER flexibility and offering some degree of finality and certainty in relation to the making of a decision by the AER. For these purposes, the draft rule adopted similar wording to that in section 107 of the NEL, which described the relevant issues as being of sufficient complexity or difficulty to warrant an extension of time.

In the directions paper, the Commission proposed an option to introduce a notification step where the NSP would be required to notify the AER if it was aware that there may

405 AER, Directions Paper submission, 2 May 2012, pp. 75-76.

be external events that could have an impact on the application before it makes its application. However, given the flexibility that would be built into the timeframe, such a notification appeared to be unnecessary in the draft rule determination. Nevertheless, the Commission encouraged NSPs to notify the AER in advance of its application if it becomes aware of matters that could potentially delay the AER in making its decision, which would assist in allowing the application to be processed more efficiently.

In the directions paper, the Commission also considered the NSPs' proposal for the AER to issue a draft of its decision where there are complex circumstances.[406] However, to the extent the complex circumstances or any lack of information preclude the AER from forming a view, there did not seem to be any value in requiring the AER to make a draft decision at that stage. The Commission considered that it would be difficult to expect the AER to prepare a draft decision in these circumstances and decided not to prescribe such a requirement. Nevertheless, the AER may also wish to seek to informally consult in the course of considering such matters.

9.2.2 Material errors

Scope for material errors

In the directions paper, the Commission sought supporting evidence to justify the AER's proposal to broaden the scope for material errors under Chapter 6. There was a lack of evidence noted in the directions paper and draft rule determination to support the view that the AER's current powers constrained its ability to revoke and substitute a regulatory determination for material errors.

NSPs also stated that there may have been opportunities for a material error to be corrected in a draft regulatory determination, but the AER has not always utilised its discretion to address the material error.[407] The AER itself observed that the circumstances justifying correction of a material error would be exceptional.[408] On this basis, the Commission decided in the draft rule determination that after the final regulatory determination is made, the regulatory determination should only be able to be changed as a result of merits review outcomes or in very clear and exceptional circumstances. Therefore, the Commission favoured keeping the scope of the material error provisions under Chapter 6 narrow and focussed on "computational" errors by the AER or situations where the AER has received false or misleading information. Provisions such as pass throughs, capex reopeners and contingent projects were considered the appropriate means by which more substantive changes to the regulatory determination should be made.

Expanding on its previous position in 2006, the Commission considered in the draft rule determination that in addition to providing certainty, transparency and maintaining the incentives built into the framework, the finality of the regulatory determinations must be preserved. For finality in a regulatory determination, the AER proposed limiting the timeframe for correcting material errors to six months following the making of the final

406 ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 196-197.

407 ENA, Directions Paper submission, 16 April 2012, pp. 78-79; Jemena, Directions Paper submission, 16 April 2012, pp. 57-58.

408 AER, Directions Paper submission, 2 May 2012, p. 74.

regulatory determination, which would balance off the AER's proposed expansion of the scope of material errors.[409] Given the Commission's decision to maintain a narrow scope for material errors under Chapter 6, this proposed time limitation for addressing material errors was considered unnecessary.

Consistent with this position, the Commission considered in the draft rule determination that the Chapter 6 provisions provided more certainty and finality in the framework than the equivalent provisions under Chapter 6A, and there should be no reason for differences between Chapters 6A and 6 with respect to these types of material errors as these only relate to computational errors or situations where the NSP has submitted false or misleading information. Therefore, the Commission decided to narrow down the broader Chapter 6A provisions with the narrower Chapter 6 provisions. This also included limiting material errors in regulatory determinations caused by false or misleading information by reference to "to the extent necessary", which is currently the case for distribution regulatory determinations, but not for transmission revenue determinations.

The Commission also noted that an alternative approach to promote certainty and finality in the final regulatory determination could be to not permit it to be revoked and substituted for material errors, as currently has been the approach of the regulator Ofgem in the Great Britain. However, the Commission considered that the limited approach in Australia is appropriate.

Amending material errors

The AER proposed that it should be able to amend, as an alternative to revoking and substituting, a regulatory determination as a result of a material error or deficiency where it is more preferable or appropriate to do so. In the directions paper, the Commission considered that the power to amend regulatory determinations would impact on the NSP's ability to have any such amendments reviewed in a merits review, as noted in some submissions.[410] In the draft rule determination, the Commission maintained its view that the provisions relating to material errors should not be changed to include a power for the AER to amend a determination as a result of a material error.

9.2.3 Shared assets

General position

In the directions paper and draft rule determination, the Commission considered that customers who pay for one type of regulated service that is provided by a shared asset should not be paying for the full cost of the asset. Instead, those customers should be receiving some benefit from the asset being used for a service other than a regulated service. In the draft rule determination, the Commission elaborated further on the rationale for shared assets.

409 Ibid.

410 ENA, Directions Paper submission, 16 April 2012, pp. 78-79; Grid Australia, Directions Paper submission, 16 April 2012, p. 13.

In the directions paper, the Commission noted that a shared assets cost adjustment mechanism could apply to transmission as well as distribution. In the draft rule determination, the Commission regarded this as consistent with the overall principle of harmonising Chapters 6 and 6A of the NER.

Cost allocation principles

With respect to a potential overlap between cost allocation principles and shared assets, the Commission noted in the draft rule determination that the cost allocation principles are limited as it would only allocate costs for future assets, as opposed to existing assets. This would create a problem when an asset that was used to provide a regulated service later becomes used to also provide an unregulated service or another regulated service. Under the cost allocation principles, as the costs have already been allocated to this asset, the mechanism cannot accommodate this change in circumstances, unless there has been a reclassification of service.

For these reasons stipulated in the draft rule determination, a shared assets cost adjustment mechanism would be available to the AER to apply to assets that provide both distribution or transmission services and any unregulated service. To avoid any doubt and potential overlap, the Commission stated that the AER's development of any shared assets cost adjustment mechanism must have regard to the cost allocation principles and the NSP's cost allocation method, and any incentives under the NER.

Restrictions on the shared assets cost adjustment mechanism

As discussed in the directions paper, the AER proposed two shared assets cost adjustment mechanisms in the form of an ex ante revenue adjustment and an ex post control mechanism adjustment.[411] It stated that the control mechanism adjustment could be used for sharing a proportion of the pre-tax profits from the unregulated activities with the users of the regulated services.[412]

In the draft rule determination, the Commission did not consider it possible for a shared assets cost adjustment mechanism to share a portion of the profit or revenue from unregulated services. By transferring a portion of this profit or revenue to customers of regulated services, the mechanism would be limiting the revenue that the NSP could earn from the unregulated service. This would have the same effect as regulating the unregulated service, which does not appear to be permitted under the NEL and NER.

Shared assets cost adjustment mechanism – cost reduction

It was decided in the draft rule determination that the shared assets cost adjustment mechanism should operate in a way that would not be based on the profit or revenue received by the NSP from the unregulated service. The best way it was considered that this could work was if the sharing was implemented through a reduction in the costs of the shared asset that are recovered from consumers of the regulated service. That is, instead of recovering 100 per cent of the costs of the shared asset from consumers of the regulated service, a lower proportion would be recovered. A number of principles would be taken into account by the AER in determining this proportion, discussed further below, one of which could be having regard to the manner in which costs have

411 AER, Rule change request, Part B, 29 September 2011, p. 60.

412 Id., p. 61.

been recovered or revenues reduced by the NSP in the past for a shared asset associated with the unregulated service. However, the shared assets cost adjustment mechanism would not apportion part of the revenue or profit from the unregulated service.

Sharing the benefit resulting from the asset being used to provide an unregulated service, as well as a regulated service, via a reduction in the costs recovered from the consumers of the regulated service, rather than by passing through a portion of the revenue or profits received from the unregulated service, means that there will be a limit on the amount of benefit sharing that is possible. For example, if the costs of the shared assets that are recovered from standard control service customers each year are $1 million in the absence of any sharing, but revenue from the unregulated use is $3 million per year, the maximum benefit that could accrue to standard control service customers would be $1 million per year.

Where the shared assets cost adjustment mechanism takes the form of a reduction in costs apportioned to consumers of the regulated services, a control mechanism adjustment including annual pricing adjustments would not appear to be appropriate. A control mechanism adjustment would only be appropriate if the adjustment was linked to an external factor, such as the amount of profit or revenue received under a contract with a third party, and this could be converted into a price or revenue adjustment in the control mechanism in a "mechanistic" way without the AER having to make a subsequent decision. Such an approach would be administratively inefficient, given that the AER would be required to annually make these adjustments, and would create too much uncertainty for the NSP.

Instead of an adjustment to the control mechanism, the reduction in the costs allocated to consumers of the regulated services would feed through the building block determination into the ARR. This reduction would be determined by the AER at a regulatory determination according to guidelines based on the principles set out below. It should reflect the part of the costs of the relevant asset which are being recovered through charging for the provision of the unregulated service. By reducing the ARR for the NSP, the amount recovered from consumers will also be reduced. By including the decision in a regulatory determination, the cost reduction will be fixed for the regulatory period covered by that determination, which provides certainty for the NSP. In addition, this decision would be subject to the scrutiny that comes from consultation as part of the regulatory determination process and any subsequent merits review.

Timing

In the draft rule determination, the Commission was of the view that the cost reduction would only be implemented at a regulatory determination, regardless of when the sharing arrangement actually commences. This means that the NSP would be required to disclose information on its shared assets as part of its regulatory proposal to the AER. It would be possible for the reduction to occur in respect of a sharing arrangement which had not yet commenced, provided it was known with enough certainty at the time of the regulatory determination. If it was not known with enough certainty then the reduction could not apply until the next regulatory determination, even if the sharing arrangement commenced prior to that determination. There would be no reconciliation or "ex post adjustment" in respect of any sharing arrangement that was put in place during the middle of a regulatory period; the cost reduction would only start from the beginning of the next regulatory period. However, the historical use or revenue of the asset could be used as a factor to forecast future sharing of such an asset. Overall, this should provide the NSP who has a sharing arrangement some certainty as to what cost reduction could be expected. The proposed shared assets cost adjustment mechanism could also take into account Jemena's previous proposal for an exemption period to be given to newly shared assets for a period of several years.[413]

In respect of an ex post adjustment, or "true up", once the actual benefits in a period of a sharing arrangement are known, the Commission considered in the draft rule determination that this should not be necessary.[414] First, if the sharing arrangements are set on the basis of a contract the revenue received should be relatively easy to predict. Second, the revenue received will be only one factor to consider in setting the cost reduction for consumers, which must be based on the cost of assets shared. Third, to the extent revenues received through the sharing arrangements change, the cost reduction can be adjusted at the next regulatory determination for the next regulatory period.

Jurisdictional arrangements

As referred to in the AER's original proposal, the Commission recognised in the draft rule determination that shared assets cost adjustment mechanisms currently exist under jurisdictional arrangements.[415] The approach that has been previously used in Queensland has been grandfathered in NER clause 11.16.3. This grandfathering extends until the next Queensland distribution determination in 2015. Since the mechanism applied is a forecast revenue adjustment made to the building blocks, this could be accommodated under the proposed rules. In South Australia, a profit sharing mechanism has been used, with a portion of the profits from unregulated activities passed onto regulated service users of the shared asset.[416] As described above, such a mechanism would not seem to be permitted under the general NEL and NER provisions.

Shared assets providing alternative control services

As noted in the draft rule determination in respect of distribution, the above approach would only address the situation where one use of the asset is to provide standard control services and another use is to provide an unregulated service. The AER also pointed out that there may be the circumstance where the asset is used to provide both alternative control services and unregulated services.[417] The Commission accepted that alternative control service customers of a shared asset should be paying costs reflective of its use for the provision of alternative control services, and agreed with the AER that there should be no reason why standard control service customers benefit from the use

413 Jemena, Consultation Paper submission, 8 December 2011, p. 107; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

414 AER, Rule change request, Part B, 29 September 2011, p. 61; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

415 AER, Rule change request, Part B, 29 September 2011, p. 59.

416 Ibid.

417 AER, Directions Paper submission, 2 May 2012, pp. 34-35.

of a shared asset to provide unregulated services, while alternative control service customers do not.

Nevertheless, some submissions on the directions paper stated that the AER's proposal would result in customers of alternative control services being over-compensated through a revenue decrement as well as a separate control mechanism, and that alternative control services should be excluded.[418] The Commission considered in the draft rule determination that the AER has considerable discretion in setting the control mechanism for alternative control services under NER clauses 6.2.5(a)-(b) and 6.2.6(b)-(c) and so may impose requirements that only permit the NSP to recover such costs associated with the provision of alternative control services as are appropriately allocated to those services. Therefore, in respect of distribution, the shared assets cost adjustment mechanism would only deal with the circumstance where the asset is used to provide a standard control service.

However, the Commission considered in the draft rule determination that, where one use of the asset is for standard control services and the other use is for alternative control services, the standard cost adjustment described above should still apply for the costs recovered from the standard control service customers.

Guidelines and principles

Bearing in mind the shared assets cost adjustment mechanism described above, the Commission considered in the directions paper and draft rule determination that to facilitate NSPs seeking out and entering into sharing arrangements of the kind discussed here, NSPs would need some certainty about how the AER would determine the cost adjustment appropriate for a particular sharing arrangement.

Part of this certainty would be provided by principles guiding the AER's determination, and which would be set out in the NER. NSPs previously raised a number of principles that could be applied in this regard.[419] In setting these principles, consistent with the NEO, the Commission took the view in the draft rule determination that the approach to a shared assets cost adjustment mechanism should:

- provide clarity and certainty on how the AER would approach sharing the costs;
- provide cost reflective prices to consumers;
- promote innovation in NSP investments; and
- be able to be implemented in practice.

On this basis, the principles listed in the draft rule determination to which the AER must have regard to were:

418 Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 35; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

419 Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ENA, Consultation Paper submission, 8 December 2011, pp. 38-39; ENA, Directions Paper submission, 16 April 2012, pp. 36-37; Energex, Directions Paper submission, 16 April 2012, pp. 2-3; Ergon Energy, Consultation Paper submission, 8 December 2011, p. 14; ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 23, 97-98; Jemena, Consultation Paper submission, 8 December 2011, pp. 107-109; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

- the NSP should be encouraged to use assets that provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of standard control services;
- a shared assets cost adjustment should not be dependent on the NSP deriving a positive commercial outcome from the use of the asset other than for standard control services;
- a shared assets cost adjustment should be applied where the use of the asset other than for standard control services is material. This means the benefit of sharing the cost of the asset based on use should outweigh the administrative costs of implementing the shared asset cost adjustment mechanism;
- the manner in which costs have been recovered or revenues adjusted in respect of the relevant asset in the past and the reasons for adopting that manner of recovery or adjustment should be taken into account;
- a shared assets cost adjustment should be compatible with the cost allocation principles and cost allocation method; and
- a shared assets cost adjustment should be compatible with incentives that the NSP may have under the NER.

The Commission considered in the draft rule determination that the above principles promoted its objectives on what the shared assets cost adjustment mechanism should achieve.

With respect to determining the appropriate portion of costs for the purposes of a shared assets cost adjustment, the Commission considered in the draft rule determination the most obvious approach is for the AER to base this on the relative use of the asset for the provision of the different kind of services such as the technical use or physical use. Another possible way could include using the ratio between the proportion of revenue from the asset for standard control services and the proportion of revenue from the asset for other than for standard control services over the current regulatory period. However, this should not be taken as precluding the AER from considering other possible bases for sharing the costs of the asset.

The Commission did not accept in the draft rule determination the principle that the NSP should only have to pass on the benefit of a shared asset if it receives a net profit as a result, which was proposed by NSPs to recognise the associated risks of the NSP with sharing arrangements.[420] In general, the NSP should bear the risk so it takes this into account when deciding whether to enter a sharing arrangement, as the Commission considered the NSP to be the party best able to assess and manage this risk.

In addition, for added certainty, the draft rule required the AER to set out in guidelines what its approach would be for determining the appropriate cost reduction for sharing arrangements, having regard to the above principles. Such guidelines may, for example, set out a particular methodology which the AER intends to use.

420 Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ENA, Consultation Paper submission, 8 December 2011, pp. 38-39; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

In the directions paper, the Commission considered including a draft rule requiring the AER to specify the shared assets cost adjustment mechanism at the framework and approach paper stage. However, the Commission decided in the draft rule determination that this would not be required because the shared assets cost adjustment mechanism would be prescribed in the NER, with supporting guiding principles and guidelines. This meant the NSP would need to submit information on its shared assets to the AER in the regulatory proposal.

9.2.4 Small scale incentive schemes

In the directions paper the Commission considered that the AER should be allowed to develop small scale pilot or test incentive schemes within an environment that limits the sum of money at risk and the length of time of the scheme. It also proposed that it would be appropriate for the AER to have the discretion to determine whether or not incentive schemes should apply at the time of a regulatory determination in Chapter 6A of the NER, consistent with Chapter 6.

In the draft rule determination, the Commission maintained its position. It elaborated that the AER should have the ability to innovate in this way without having to go through the full rule making process, which may be overly burdensome. It would be good regulatory practice to test or pilot a scheme before full implementation as incentive schemes could otherwise be introduced that lead to unexpected and perhaps unwelcome outcomes as identified by Professor Littlechild.[421] A permanent scheme should, however, be subject to the rule making test given the potential impact of the scheme.

The extent of a small scale incentive scheme should be limited by the sum of money at stake, ie revenue at risk, and the period for which the scheme lasts. In addition the scheme should be subject to consultation with relevant NSPs and other stakeholders before being implemented.

The sum of money at stake should balance the need to be high enough to understand how the scheme would be likely to operate but not so high that there would be a significant impact on a NSP if the scheme did not operate as intended. The Commission considered that this balance would be met if the revenue at stake was one per cent of revenue for a regulatory year if the NSP agrees with this amount, or up to 0.5 per cent of revenue for a regulatory year if the NSP does not. The lower revenue at risk that can be placed on the scheme if the NSP does not agree to it was to reflect that the NSP would have no choice as to whether a scheme is applied to it and the scheme would not have been subject to the rule making process. The AER would also be able to undertake paper trials, ie a scheme in which no money is at risk, as part of its discretion. The limits described above were considered high enough such that the effectiveness of a scheme would be able to be determined.

In terms of a restriction on the period of a scheme, any scheme would last for a maximum of two regulatory periods. If the AER wished the scheme to continue after this point then it would need to apply for the scheme to be made permanent through the rule change process. This length of time should be long enough for the AER to make

421 Stephen Littlechild, Advice to the AEMC on Rule Changes, 11 February 2012, p. 19.

a decision on whether the scheme was effective and therefore whether it would be a permanent scheme in the NER.

In addition to these requirements, the Commission did not agree that the draft rule should require the AER to seek the agreement of the NSP before commencing the trial as this would simply give the NSP a right of veto. However, as noted above, the revenue that could be put at risk from the scheme would be lower if the NSP did not agree to the scheme. Restricting the scheme to only parts of a NSP's operations would also overly restrict the AER.

Consistent with the general approach in respect of the rule change, the AER would have to take into account certain factors when developing these schemes. The principles developed for capex sharing schemes were considered broadly appropriate here. These addressed key issues, such as the fact that a scheme should not penalise efficient NSPs. At the same time, the principles were broad so that they did not overly restrict the AER. These factors were also in line with those put forward by the AER for its proposed power to develop other incentive schemes.[422]

The Commission maintained that it would be appropriate to allow the AER to have discretion to determine whether incentive schemes should apply at the time of a regulatory determination in Chapter 6A of the NER, consistent with Chapter 6.

9.3 Submissions

9.3.1 Uncertainty regime

Capex reopeners

The AER supports the introduction of the capex reopener and contingent projects regime for distribution as it considers this to be an additional option and be low in implementation costs.[423] With respect to capex reopeners, some DNSPs also expressed their support for including this in distribution to deal with unforeseen events which require significant capex for providing reliability and security.[424]

Contingent projects

On the introduction of contingent projects in distribution, most DNSPs maintain their previous objections to its inclusion.[425] Alternatively, they consider if it is introduced in distribution, then the AER should not be able to "micro-manage" their networks which would mean the AER should not be able to: have regard to whether the proposed expenditure should be included as a contingent project; and propose its own contingent projects by transferring expenditure as a contingent project.[426] Instead, the AER would

422 AER, Rule change request, Part B, 29 September 2011, p. 57.

423 AER, Draft Rule Determination submission, 5 October 2012, p. 14.

424 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 27.

425 ENA, Draft Rule Determination submission, 4 October 2012, pp. 41-44; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 27-29; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 5.

426 ENA, Draft Rule Determination submission, 4 October 2012, pp. 41-44.

be applying the capex criteria to determine whether it is satisfied with the forecast or otherwise substitute this with its own.[427]

Threshold for contingent projects

Notwithstanding the DNSPs' opposition to introducing contingent projects in distribution, they consider that if it was to be required, then the threshold should only apply to very large individual projects in the vicinity of $30 million or five per cent of the ARR.[428] They consider that this value corresponds to projects that are large in size, small in number, based on well-defined trigger events, and proportionate to the size and value of the network.[429] Further, they consider that it should be made clear that the regime only applies to capex for an individual project and not capex related to more than one identifiable project.[430]

On the other hand, the DNSPs do not consider it appropriate to link the distribution contingent project threshold to the RIT-D threshold because of their fundamental difference.[431] The RIT-D threshold assumes it would be desirable in principle for the test to be applied to all projects, but that it should be limited to keep administrative costs proportionate to the benefit.[432] In contrast, the threshold for contingent projects should identify projects that cannot be accommodated in a standard price cap regime with ex-ante forecasts.[433] On the other hand, the NSPs then suggest that linking the characteristics of transmission projects might make it convenient for transmission contingent projects to be linked to the higher threshold of the RIT-T.[434] The joint submission from SA Power Networks, CitiPower and Powercor clarified that they did not support the contingent projects regime, and its reference to a $5 million threshold in its previous submission was in the context of pointing out an inconsistency between the AER's proposed $10 million threshold for distribution contingent projects and its link to the RIT-D threshold of $5 million.[435]

Materiality threshold for cost pass through events

With respect to the materiality threshold for cost pass through applications in distribution, some DNSPs maintain that the threshold should be set to $1 million to provide for certainty, rather than at one per cent of the ARR.[436] However, NSPs consider that if the one per cent threshold were to apply then it should cover an annual culmination of multiple events with the total impact considered as part of the threshold, which would be based on the cash flow impact (ie actual costs incurred) as opposed to

427 Ibid.

428 Ibid.

429 Ibid.

430 Ibid.

431 Ibid.

432 Ibid.

433 Ibid.

434 Ibid.

435 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 29.

436 Id., pp. 6-7, 26-27.

the revenue impact.[437] They consider this approach would be consistent with the RPP to allow NSPs a reasonable opportunity to recover at least their efficient costs.[438]

In contrast, the AER has shifted from its original proposal and considers that the materiality threshold may be too low and may capture immaterial applications.[439] It proposes that this threshold should be treated as one factor, but not the only condition to determine the materiality of an application.[440]

9.3.2 Material errors

In the absence of any evidence to demonstrate that the AER has been constrained under the current arrangements for material errors, NSPs do not support changing the current NER provisions under Chapters 6 and 6A, except for making minor amendments to clarify the provisions.[441]

9.3.3 Shared assets

In general, the NSPs and MEU support the shared assets cost adjustment mechanism.[442] However, NSPs consider that further drafting is required to clarify the Commission's intended design.[443] Otherwise, they consider that the Commission's approach to applying a revenue requirement adjustment cannot be achieved with respect to revenue received from shared assets.[444]

NSPs support the approach where revenue is shared between assets with the RAB then allocated according to the types of services used for that asset, as opposed to the capex at the point it enters the RAB.[445] NSPs also support the Commission's approach to allow assets to be shared between standard control or prescribed transmission services with unregulated services.[446] However, they consider that the types of services that could be covered under a shared asset arrangement should be extended so that an asset can be shared between: standard control and alternative control, negotiated and unregulated services in distribution; and prescribed transmission and negotiated or unregulated services in transmission.[447]

---

437 Ibid; ENA, Draft Rule Determination submission, 4 October 2012, pp. 44-46; Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

438 Ibid.

439 AER, Draft Rule Determination submission, 5 October 2012, pp. 14-15.

440 Ibid.

441 ENA, Draft Rule Determination submission, 4 October 2012, p. 73; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14-15.

442 ENA, Draft Rule Determination submission, 4 October 2012, pp. 46-49; Energex, Draft Rule Determination submission, 4 October 2012, p. 2; Ergon Energy, Draft Rule Determination submission, 7 October 2012, pp. 7-8; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 11-12; MEU, Draft Rule Determination submission, 4 October 2012, p. 28.

443 Ibid.

444 Ibid.

445 Ibid.

446 Ibid.

447 Ibid.

To effect the shared assets cost adjustment mechanism, NSPs propose the RAB would include any expenditure for an asset that may be used for standard control or prescribed transmission services.[448] This would result in a "gross figure based" RAB, which can then be subsequently allocated between services that share the asset.[449] This would also require a change to the cost allocation principles so that it refers to the allocation of assets rather than capex.[450]

Associated to this, NSPs consider that past capex that has already been shared should be accounted for under the shared assets cost adjustment mechanism.[451] However, they consider their proposed "gross figure based" RAB would resolve this issue, as opposed to a RAB with only part of the asset value included.[452] This may result in a potential double allocation of costs if the RAB had previously been treated as a "gross figure based" RAB, which can be resolved by specifying that the AER needs to ensure that efficient allocation of costs is made.[453]

NSPs support the first principle which places a positive incentive upon NSPs to identify additional services for assets that provide prescribed transmission or standard control services.[454] However, they do not agree that implementing a shared cost assets arrangement should be contingent on whether there is a positive commercial outcome from such sharing.[455] At a minimum, they consider that the NSP should expect on an ex ante basis to be left whole from allocating the assets, which would be inferred from the first principle and the NEO.[456]

Grid Australia considers that transmission assets can be solely constructed for providing negotiated or unregulated services, and there is no reason for these particular assets to be shared and included in the RAB.[457] They note that schedule 6A.2 already provides for the situation where that asset later provides prescribed transmission services and is subsequently included in the RAB.[458]

9.3.4 Small scale incentive schemes

NSPs broadly consider the draft rule determination strikes the right balance between allowing for regulatory innovation and retaining important distinctions between rule making and regulatory application.[459] Other stakeholders did not comment on this aspect of the draft rule determination.

---

448 Ibid.

449 Ibid.

450 Ibid.

451 Ibid.

452 Ibid.

453 Ibid.

454 Ibid.

455 Ibid.

456 Ibid.

457 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 11-12.

458 Ibid.

459 ENA, Draft Rule Determination submission, 4 October 2012, p. 36.

9.4 Analysis

9.4.1 Uncertainty regime

Contingent projects

With respect to limiting contingent projects to capex for an individual project and not capex related to more than one identifiable project, the Commission considers it is unnecessary to specify this in the NER.[460] The NER provides that the contingent project needs to be assessed and the associated trigger event defined in the regulatory determination, which determines the scope of the contingent project.

Also, by setting the thresholds for these mechanisms at the correct level, as further discussed below, only the largest projects or events, which could be expected to have longer lead times, would be captured. Accordingly the perceived "micro management" of the process and administrative burden placed on stakeholders would be limited, without the need to consider changing the current design of the uncertainty regime.[461] In addition, experience with the uncertainty regime in Chapter 6A indicates that the incentive effects of the ex ante allowance provided under the regulatory determination process would not be substantially weakened. The Commission notes that under Chapter 6A, these mechanisms have not so far created a significant burden, given that the contingent project mechanism has only been triggered twice while capex reopeners have never been used. However, given the number of contingent projects proposed on an ex ante basis via the regulatory determination process, it may be considered to be currently a significant burden on the AER to assess these.

Threshold for contingent projects

In considering the ENA's reasons for the inappropriateness of basing the distribution contingent project threshold on the RIT-D and proposing an alternative threshold of $30 million or five per cent of the ARR (whichever is greater), the Commission has reconsidered its past position.[462]

In 2006, the AEMC considered that the relationship between the contingent project threshold for transmission and the regulatory test threshold had the advantage that it would be the same amount necessary for the application of the regulatory test to new augmentation investment.[463] Part of this was also based on information supplied by the Electricity Transmission Network Owners Forum (ETNOF) (now Grid Australia) and considering a number of indicative costs for potential contingent projects.[464]

In the draft rule determination, the Commission noted that the regulatory test threshold referred to in the 2006 determination had been replaced with the RIT-T, but the contingent project threshold had not been adjusted in the NER to reflect this change. On this basis, the Commission considered that the threshold should have been lowered to $5 million to reflect its original intention ie from $10 million to $5 million. Conveniently,

460 Id., pp. 41-44.

461 Ibid.

462 Ibid.

463 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 59.

464 Id., pp. 58-59.

this contingent project threshold for transmission would have then been the same as in the proposed approach for distribution as they would be both linked to their respective RIT-T and RIT-D thresholds which have the same monetary value.

On the NSPs' point that the distribution contingent project should be set at a level equivalent to the characteristics of transmission contingent projects, the Commission does not accept that the monetary threshold should be different.[465] This would imply that projects in distribution are generally larger than those in transmission, which is questionable. Instead, the thresholds should be at the same level. On this basis, to determine an appropriate threshold, the anticipated value of projects accepted by the AER in recent transmission regulatory determinations was examined. These are shown in Appendix B.

As can be seen in Appendix B, for ElectraNet and Transend, half of their current contingent projects would have not fallen under the NSPs' proposed $30 million contingent project threshold. However, Powerlink and TransGrid would not have been affected. In addition, if the threshold is the greater of $30 million and five per cent of the ARR or MAR, increasing one boundary of the threshold to $30 million will mean for some NSPs that this value will become greater than their five per cent of the ARR or MAR, and therefore their threshold will be based on a higher value of $30 million. This demonstrates that under the NSPs' proposal, the number of contingent projects to be proposed, assessed and defined, and volume of applications submitted to the AER (if they had been triggered) would be reduced. Further, the fact that only two contingent projects have been triggered to date (noting the Powerlink regulatory period has only commenced mid 2012) may suggest that very uncertain projects are being proposed as contingent projects. Therefore, the administrative burden placed on the AER to consider a number of contingent projects during the regulatory determination process would be reduced by applying a higher monetary threshold for contingent projects. This issue becomes more evident if the AER considers multiple applications from different NSPs concurrently.

NSPs have suggested that the reason for the small number of triggered contingent projects is because the AER has taken a narrow interpretation of the trigger event and not defined it properly.[466] In the end, this is a matter for the AER.

For the above reasons, the Commission has decided that the contingent project threshold will be the greater of $30 million or five per of the ARR or MAR for both distribution and transmission. Future projects with a monetary value of between $10 million and $30 million will have to be assessed by the AER as part of the revenue allowance under the regulatory determination. This means that there is an appropriate balance between providing sufficient scrutiny of adequately large projects under the contingent project regime and other projects under the regulatory determination, and a reduction in the administrative burden placed on the AER and NSPs.

In fixing the threshold to the greater of $30 million or five per of the ARR or MAR, guidelines for varying the threshold and indexation of the threshold may be relevant

465 ENA, Draft Rule Determination submission, 4 October 2012, pp. 41-44.

466 Ibid.

considerations.[467] However, for reasons of certainty and administrative simplicity in applying the threshold, these options have not been pursued further. Further, changing the threshold value from the current arrangements can be considered as only a minimal change to design of the contingent projects regime as opposed to introducing indexation or a new guideline process.

Materiality threshold for cost pass through events

The Commission does not accept the NSPs' proposal for an annual accumulation of multiple cost pass through events to be considered when assessing the materiality of the cost pass through event application, nor setting the threshold to $1 million.[468] The Commission does not accept the AER's proposal to make it only one factor for consideration in assessing materiality.[469] On the one hand, the AER considers the threshold may be too low; while on the other, the NSPs consider it too high. This highlights the problem with not setting the materiality threshold as it creates divided views on its objective. As the AEMC stated in 2006, setting the materiality threshold to one per cent of the MAR is important to promote stability and predictability of the regime for both the regulator and the NSP.[470] In the absence of a specified materiality threshold, it would lead to greater uncertainty and an increase in administrative costs for the AER to determine a material event.[471]

Proceeding on the basis that the materiality threshold is set at one per cent of the ARR or MAR, the NSPs' proposed accumulation of multiple cost pass through events for a given year cannot be accepted. Firstly, the NSPs' proposal would dilute the effect of the materiality threshold. Secondly, the experience in transmission demonstrates that a non-cumulative materiality threshold can be applied without any problems. Finally, the approach reflects the AER's current practice in applying the materiality threshold for cost past through applications.

In terms of whether the costs associated with the materiality threshold are based on cash flow impact or revenue impact, that is a matter of detail for the AER to decide with respect to each particular application.[472] The Commission considers that it is sufficient to refer to the ARR as defined in the NER, without further elaborating on its existing definition.

For the above reasons, the materiality threshold for cost pass through events will be set at one per cent of the ARR for distribution.

467 Victorian DPI, Consultation Paper submission, 8 December 2011, pp. 30-32.

468 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 6-7, 26-27; ENA, Draft Rule Determination submission, 4 October 2012, pp. 44-46; Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

469 AER, Draft Rule Determination submission, 5 October 2012, pp. 14-15.

470 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 106.

471 Ibid.

472 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 6-7, 26-27; ENA, Draft Rule Determination submission, 4 October 2012, pp. 44-46; Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

9.4.2 Material errors

While the material error provisions have not been used extensively, the Commission considers that the provisions under Chapter 6 provide for more certainty and finality in the framework than the equivalent provisions under Chapter 6A. Further, there should be no reason for differences between Chapters 6A and 6 with respect to these types of material errors as these only relate to computational errors or situations where false or misleading information has been submitted. Therefore, the broader Chapter 6A provisions should be narrowed down to be consistent with the Chapter 6 provisions. This also includes limiting material errors in regulatory determinations caused by false or misleading information by reference to "to the extent necessary", which is currently the case for distribution regulatory determinations, but not for transmission revenue determinations.

9.4.3 Shared assets

Services covered under the shared asset cost adjustment mechanism

In designing the shared asset cost adjustment mechanism, the Commission intends that costs that customers incur for a service should be cost reflective. The shared assets cost adjustment mechanism allows users of an asset to benefit where the asset is used for a different service.

In the draft rule determination, reference was made to the shared asset cost adjustment mechanism applying where the other use of the asset is an alternative control service.[473] In fact, the nature of the other types of regulated services (including alternative control services and negotiated services) means that the possibility of sharing is less likely. If, for example, a standard control service asset is used for alternative control service purposes, it is more likely that the service as a whole would be reclassified, making a sharing arrangement unnecessary. For simplicity, it is preferable to restrict the shared assets cost adjustment mechanism to arrangements where one use of an asset is for a standard control service or prescribed transmission service and the other use is for an unregulated service. Also, this would reduce the possibility of an overlap between the shared assets cost adjustment mechanism and the cost allocation principles which would have resulted in a double recovery.

Some submissions in response to the draft rule determination sought the inclusion of negotiated services within the shared assets cost adjustment mechanism. Given the flexibility in the way costs for negotiated services are recovered, the Commission does not see it as necessary for the shared assets cost adjustment mechanism to extend to negotiated services. A similar comment was made in respect of alternative control services in the draft rule determination.[474]

Gross figure based RAB

The Commission does not intend to alter the current way in which capex is allocated to the RAB based on only standard control services. To change it to become a "gross figure

473 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 212.

474 Id., p. 211.

based" RAB as proposed by the NSPs would result in a significant change in the existing way in which cost allocation and ring fencing guidelines operate. To effect such a change would create too much uncertainty as to the setting of the RAB and result in a volatile RAB for each regulatory reset.

The purpose of the shared assets cost adjustment mechanism is to address the situation where an asset used for a standard control service or prescribed transmission service is subsequently shared with an unregulated service, and the AER then could apply a revenue adjustment without resorting to reallocating the initial RAB value. If at the point where the capex enters the RAB it has been recognised that the asset is being used for unregulated services, and only the standard control services portion is included in the RAB, then the shared assets cost adjustment mechanism should not need to apply. This is because the mechanism is based on the presumption that the asset has not been shared at that stage. This should clarify the treatment of past assets where part of the past capex has already been allocated to other unregulated services. In that scenario, the shared assets cost adjustment mechanism would not be needed. To reinforce this point, a principle has been included which requires the AER to have regard to the manner in which costs have been recovered or revenues reduced with respect to the asset in the past.

Positive commercial outcome

The Commission reiterates its position that, in general, the NSP should have to bear some risk in the sharing arrangements so it takes that risk into account when deciding whether to enter a sharing arrangement of an asset. The NSP will be in the best position to assess and manage this risk. The NSP needs to be prudent in making its investment decisions when going into sharing arrangements. A benefit that the NSP may receive in sharing the asset is the likely potential to substantially gain revenue from that arrangement; while the only benefit to the existing customer is a reduction in its costs. It is the NSP's decision to share the asset with the objective of making a profit, balanced against whether it is a prudent decision to enter into such an arrangement. Otherwise, there would be no disincentive for the NSP to share an asset irrespective of the risk as it would pass on the costs to customers if it makes a bad investment decision.

9.4.4 Small scale incentive schemes

The Commission notes that the majority of the issues raised by NSPs on small scale incentive schemes were also raised in relation to capex sharing schemes. In particular NSPs suggested that:

- the AER should be required to compensate NSPs for the expected liability under the scheme where a scheme is asymmetric; and
- NSPs should have certainty on applicable schemes at the framework and approach stage.[475]

These issues are considered in sections 7.4.1 and 7.4.2.

The Commission does not agree with SP AusNet that the AER and NSPs should be allowed to agree on a revenue at risk higher than currently provided for. Given that the

475 ENA, Draft Rule Determination submission, 4 October 2012, pp. 36-38.

schemes will not have been subject to the rule making test the revenue at risk is appropriate. This will provide protection to both consumers and NSPs.

9.5 Guidance on final position rule

9.5.1 Uncertainty regime

Capex reopener and contingent projects in distribution

Generally, the uncertainty regime has been aligned in distribution with transmission. This means that the capex reopener, contingent project and cost pass through arrangements are broadly the same.

Threshold for capex reopener and contingent project applications in distribution

For capex reopeners, the threshold for distribution is capex that exceeds five per cent of the value of the roll-forward RAB for the first year of the regulatory period. The same threshold applies to both transmission and distribution.

For contingent projects, the threshold for both distribution and transmission is the greater of $30 million or five per cent of the ARR or MAR, respectively. The same threshold applies to both transmission and distribution.

Materiality threshold for cost pass through applications in distribution

The materiality threshold for cost pass through applications in distribution is one per cent of the DNSP's ARR. This brings it into line with the threshold applied in transmission.

Other aspects of cost pass through applications

Under the existing rules, the roll-forward RAB for the next regulatory period must include all capital costs incurred in the current regulatory period. This may unintentionally include pass through amounts associated with capital costs which have already been approved under the cost pass through arrangements. For clarity, the final position rule will amend the NER to reflect the fact that cost pass through amounts that have already been recovered in a regulatory period cannot be recovered again in the roll-forward of the RAB for the next regulatory period.

For the reasons explained above, the timeframes for the AER to make a decision on applications related to cost pass throughs, contingent projects and capex reopeners will be aligned at 40 business days from the time the AER receives the application and any additional information it requires from the NSP. This timeframe will be able to be extended by up to a further 60 business days if the AER determines that there are issues of sufficient complexity or difficulty that warrant such an extension. Such issues may require the AER to seek expert advice or consult with interested parties on a particular matter.

If the decision needs to be delayed to wait for further information from a third party, then a "stop the clock mechanism" will be able to apply. Such a third party may be a governmental authority from which the AER has requested information or a judicial body or a royal commission that the AER anticipates will make publicly available information that is relevant to the NSP's application.

In the case of either a time limit extension or the application of the "stop the clock" mechanism, the AER will be required to notify the NSP of the extension or delay no later than 10 business days before the date that the AER would have to make its decision (ie no later than 30 business days from the time the AER receives the application) and also publish notice of this on its website. In addition, the AER may also apply the "stop the clock" mechanism after it had already extended the period, but the AER would still be required to notify the NSP no later than 10 business days before the expiration of the extended date (ie no later than 90 business days from the time the AER receives the application). The AER will also be required advise the NSP when the "stop the clock" mechanism has ceased to apply, in which case it must again publish a notice on its website to this effect.

Case scenario – example of the "stop the clock" mechanism and extending timeframe by 60 business days

- On 1 July 2013, the AER receives from a NSP in New South Wales an application for a positive cost pass through within 90 business days of the positive event occurring. The application relates to a bushfire.
- At the time of the application, the AER is informed by the NSP that there is a royal commission on the bushfire and the outcome of the decision by the royal commission may have an impact on whether the NSP can recover for that cost pass through and, if allowed, potentially also the amount that the NSP can recover. The royal commission decision will not occur until after the normal decision-making timeframe for the AER, ie more than 40 business days after the AER received the NSP's application and such additional information regarding the application as the AER requires from the NSP.
- On 15 July 2013, the AER notifies the NSP that in order to determine the NSP's application, it requires information that it anticipates will be made publicly available by the royal commission. This notification occurs no later than 10 business days before it would have had to make the decision. The AER also publishes a notice on its website stating that the clock has stopped.
- On 29 November 2013, the royal commission publishes its decision. As a result of this, the "stop the clock" mechanism ceases to apply. The AER would inform the NSP and publish a notice on its website stating that the clock has restarted. The Commission would also expect the AER to state in that notice the date on which the AER will make its decision. In this case, it will be 30 business days after 29 November 2013, which will be 15 January 2014, taking into account public holidays. This is because 10 business days have already elapsed between 15 July 2013 and the time the clock stopped.
- However if, upon reviewing the royal commission decision, the AER determines that it requires more time to address a complex question related to the application, the AER could extend the decision-making period by a maximum period of a further 60 business days. To do so, the AER would need to notify the NSP of its decision to extend by no later than 10 business days before it would otherwise have had to make its decision on 15 January

2014. Therefore, the AER would need to give its notice, with respect to extending the period by the maximum of 60 business days, no later than 31 December 2012. The AER would also need to publish notice of the extension on its website as soon as reasonably practicable. The maximum additional period for the AER to make its decision will then expire on 10 April 2014.

- Note: In the scenario above, the "stop the clock" mechanism could only be triggered by the royal commission. The "stop the clock" mechanism does not apply to considering complex or difficult questions on the matter, where the timeframe can only be extended by a maximum additional period of 60 business days.

Given the introduction of capex reopeners and contingent projects for distribution, the timeframes for the AER to decide on these applications have been aligned with those in transmission.

Another consequential change relates to the decision making timeframe for negative cost pass through applications. The Commission notes that there is currently no set decision-making timeframe for this type of application, although a timeframe exists on when the application needs to be made. Previously in the Chapter 6A rule determination, the AEMC noted that there are asymmetries between positive and negative pass through applications that justify a difference in their treatment. However, with respect to decision-making timeframes, there should be no difference as the AEMC in 2006 recognised for capex reopeners and contingent projects. The decision-making timeframe for negative pass through applications has therefore been aligned so that there is a "standard" 40 business day timeframe with an option to extend as with the other types of applications. In addition, the AER will expressly be required to notify all NSPs of the occurrence of a negative change event if that event is not notified by the NSP to the AER and the AER proposes to determine a pass through amount.

However, unlike for positive change events, if the AER fails to make a pass through determination in respect of a negative change event within the 40 business day time limit, then the AER will be taken to have determined a zero pass through amount, noting that this 40 business day period can still be extended to accommodate issues that are difficult, and that the "stop the clock" mechanism will still apply where the AER is waiting on information from a governmental authority, judicial body or royal commission. As noted above, the reason for the different treatment of a default decision for negative cost pass throughs compared to positive cost pass throughs is due to the asymmetries between positive and negative pass through applications.

9.5.2 Material errors

Aligning the Chapter 6A provisions with the Chapter 6 provisions with respect material errors means that the AER will now only be able to revoke and substitute a transmission revenue determination or amend a pricing methodology for the following kinds of material errors or deficiencies:

- a clerical mistake or an accidental slip or omission;
- a miscalculation or misdescription;

- a defect in form; or
- a deficiency resulting from the provision of false or materially misleading information to the AER.

As with Chapter 6, for Chapter 6A the substituted revenue determination or amended pricing methodology will only be able to be varied from the revoked revenue determination or existing pricing methodology to the extent necessary to correct the relevant material error or deficiency.

9.5.3 Shared assets

The following case study is provided in this section to explain how the shared assets cost adjustment mechanism could work.

Case scenario

- In year 2 of a regulatory period the NSP enters into a commercial agreement with NBN Co to allow NBN Co to use electricity poles currently used for standard control service purposes. The rate is $2,000 per pole per year. The NSP's costs are $500 per pole per year.
- Given that this occurs during a regulatory period, no shared assets cost adjustment mechanism is applied until the next regulatory determination.
- In its regulatory proposal for the next regulatory determination, the NSP provides details of the shared assets in accordance the AER's regulatory information instrument.
- During the regulatory determination process, the AER decides whether to apply the shared assets cost adjustment mechanism in respect of the NBN arrangements for the next regulatory period. In making this decision, the AER takes into account the guidelines on how to apply the shared assets cost adjustment mechanism and the principles on whether a shared assets cost adjustment mechanism should apply. Some considerations at this point could include the materiality of the shared asset.
- Next, the AER would need to decide on the reduction in the costs for the assets that should not be recovered from standard control customers based on the guidelines. However, it would not directly pass through any of the profits or revenue gained by the NSP as a result of providing NBN Co access to its asset. A possibility could be to base this decision on the number of customers who will benefit from the electricity poles being used to provide NBN services compared to the number of customers who receive standard control services through the use of those electricity poles. For the purposes of this exercise, it may be too difficult to determine the number of customers, but it may be easier to determine that there is an equal share in the technical and/or physical use of that pole for standard control services and NBN services. It may decide the cost reduction should be on a pole by pole basis over the forthcoming regulatory period.
- Once the AER determines the appropriate reduction of costs for standard

control service customers, the AER needs to incorporate this into its building block determination. This determination leads to adjustments being made to the ARR and therefore being reflected in pricing to customers in the annual pricing approval process. In this case, based on the asset being shared according to physical and/or technical use, which has been attributed at 50 per cent, the reduction in the ARR is $250 per pole per year. This reduction only starts to apply from the following regulatory period and there would be no cost reduction for the period in which the commercial agreement was first put in place.

9.5.4 Small scale incentive schemes

The final position rule is intended to give the AER a broad discretion as to the schemes it may design. The schemes are intended to provide for incentives not already covered by the existing incentive schemes in the NER and may cover matters not related to expenditure by NSPs. For example, the AER could design a scheme which provides rewards for NSPs which engage more effectively with consumers. The final position rule is intended to provide broad discretion so that the AER could develop any type of scheme that contributes to the NEO.

The principles are consistent with those for capex sharing schemes and therefore the guidance for these principles in section 7.5.2 is also appropriate here. Similarly, as with capex sharing schemes the AER is to set out its likely approach to the application of a scheme to a particular NSP in the framework and approach paper for the NSP. The NSP can then set out in its regulatory proposal how it proposes the scheme should apply, including any proposed values. The AER is to then set out how the scheme will apply to the NSP in the draft and final regulatory determination for the NSP.

Abbreviations

ACT	Australian Competition Tribunal
AEMC or Commission	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
APIA	Australian Pipeline Industry Association
ARR	annual revenue requirement
ATA	Alternative Technology Association
Brattle	The Brattle Group
capex	capital expenditure
CAPM	Capital Asset Pricing Model
CPA	Competition Principles Agreement
DBP	Dampier Bunbury Pipeline
DNSP	distribution network service provider
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ENA	Energy Networks Association
ERA	Economic Regulator Authority
ESAA	Energy Supply Association of Australia
ESCV	Essential Services Commission of Victoria
ETNOF	Electricity Transmission Network Owners Forum
EUAA	Energy Users Association of Australia
EURCC	Energy Users Rule Change Committee
FIG	Financial Investor Group
IPART	Independent Pricing and Regulatory Tribunal
LMR	Limited Merits Review
MAR	maximum allowed revenue
MCE	Ministerial Council on Energy
MEU	Major Energy Users
NBN	National Broadband Network

NEL	National Electricity Law
NEM	National Electricity Market
NEO	national electricity objective
NER	National Electricity Rules
NGL	National Gas Law
NGO	national gas objective
NGR	National Gas Rules
NPV	net present value
NSP	network service provider
NSW T-Corp	NSW Treasury Corporation
OEB	Ontario Energy Board
opex	operating expenditure
PTRM	post-tax revenue model
QTC	Queensland Treasury Corporation
RAB	regulatory asset base
RIIO	Revenue = Incentives + Innovation + Outputs
RIN	Regulatory Information Notice
RIPUC	Rhode Island Public Utilities Commission
RIT-D	Regulatory Investment Test for Distribution
RIT-T	Regulatory Investment Test for Transmission
RPP	Revenue and Pricing Principles
SCER	Standing Council on Energy and Resources
SCO	Standing Committee of Officials
SFG	Strategic Finance Group Consulting
SORI	Statement of Regulatory Intent
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
UE and MG	United Energy and MultiNet Gas
Victorian DPI	Victorian Department of Primary Industries
WACC	Weighted Average Cost of Capital

A Detailed examples of potential capex sharing schemes

This appendix includes a non-exhaustive list of possible ways in which the AER might design a capex sharing scheme under the draft rules.[476]

Figure A.1 below presents two different models: Model 1 presents a stylised example similar to that provided by the ENA's consultants of a capex efficiency carry-over scheme with a five year carry-over period using a WACC of 7.5%; Model 2 presents a stylised example of the ex-ante or fixed incentive rate scheme previously used by Ofgem.

Figure A.1 Examples of efficiency carryover scheme and ex ante incentive rate scheme with periodic true-up

Model 1: ESC "capex efficiency carry over" scheme										
Year	1	2	3	4	5	6	7	8	9	10
Forecast capex	300	330	270	300	330					
Actual capex	280	310	300	290	320					
Underspend	20	20	-30	10	10					
Annual financing benefit	1.50	1.50	-2.25	0.75	0.75					
Year 1 benefit	1.50	1.50	1.50	1.50	1.50					
Year 2 benefit		1.50	1.50	1.50	1.50	1.50				
Year 3 benefit			-2.25	-2.25	-2.25	-2.25	-2.25			
Year 4 benefit				0.75	0.75	0.75	0.75	0.75		
Year 5 benefit					0.75	0.75	0.75	0.75	0.75	
Benefit / Carry over	1.50	3.00	0.75	1.50	2.25	0.75	-0.75	1.50	0.75	0.00
Discount factor (to end of year 5)	1.38	1.29	1.20	1.11	1.04	0.96	0.90	0.83	0.78	0.72
Total benefits (PV at end year 5)	39.02									
DB benefits (PV at end year 5))	12.73									
Incentive rate	32.62%									

Model 2: Ex-ante incentive rate with true-up at start of regulatory period					
Annual underspend	20	20	-30	10	10
Total Benefits (PV at end year 5)	39.02				
Target share of underspend (PV at end year 5)	12.73				
Benefit already received					
Cumulative underspend	20	40	10	20	30
Financing benefit from underspending	1.5	3	0.75	1.5	2.25
Total benefit already received (PV at end year	10.84				
Additional benefit required (PV at end year 5)	1.88				
Realised incentive rate	32.62%				

In the Model 1 scheme, the business has a total underspend across the five years of $30 million in nominal terms. This has a present value of $39 million at the end of year 5. In keeping with earlier Australian schemes the benefit to the business is taken to be the financing cost forgone from having underspent the capex allowance contained in the allowed revenue requirement. This has a present value of $12.7 million (at the end of year 5) leading to the business retaining 32.6 per cent of the available benefit.

The Model 2 scheme is designed to achieve the same incentive rate as that obtained from Model 1, namely 32.6 per cent, for illustrative purposes. Again, the NSP obtains a financing benefit from having underspent its capex allowance although in this case that only goes through to the end of the current regulatory period. Again the present value of the underspend is $39 million (at the end of year 5) and the NSP receives a financing benefit of $10.8 million through to the end of the regulatory period. To achieve the specified incentive rate of 32.6 per cent the NSP requires total benefits of $12.7 million in present value terms (at the end of year 5) meaning an additional benefit of $1.9 million will have to be given to the NSP in the form of additional allowed revenue requirement at the start of the next regulatory period.

Figure A.2 provides a stylised example of how a scheme involving an annual true up of efficiency gains and losses (as Ofgem plans to use) might work (Model 3).

476 These examples have been developed with advice from Economic Insights.

Figure A.2 **Example of ex ante incentive rate scheme with lagged annual true-up**

Model 3: Ex-ante incentive rate with annual lagged true-up										
Year	1	2	3	4	5	6	7	8	9	10
Forecast capex	300	330	270	300	330					
Actual capex	280	310	300	290	320					
Underspend	20	20	-30	10	10					
Year 1 effect										
Underspend	20									
Total Benefits (PV at end year 2)	22.29									
DB's target share of benefit	7.27									
Benefit already received										
Financing benefit from underspending	1.50									
Benefit already received (PV at end year 2)	1.67									
Additional benefit required (PV at end year 2)	5.60									
Year 2 effect										
Underspend		20								
Total Benefits (PV at end year 3)		22.29								
DB's target share of benefit		7.27								
Benefit already received										
Financing benefit from underspending		1.50								
Benefit already received (PV at end year 3)		1.67								
Additional benefit required (PV at end year 3)		5.60								
Year 3 effect										
Underspend			-30							
Total Benefits (PV at end year 4)			-33.44							
DB's target share of benefit			-10.91							
Benefit already received										
Financing benefit from underspending			-2.25							
Benefit already received (PV at end year 4)			-2.51							
Additional benefit required (PV at end year 4)			-8.40							
Year 4 effect										
Underspend				10						
Total Benefits (PV at end year 5)				11.15						
DB's target share of benefit				3.64						
Benefit already received										
Financing benefit from underspending				0.75						
Benefit already received (PV at end year 5)				0.84						
Additional benefit required (PV at end year 5)				2.80						
Year 5 effect										
Underspend					10					
Total Benefits (PV at end year 6)					11.15					
DB's target share of benefit					3.64					
Benefit already received										
Financing benefit from underspending					0.75					
Benefit already received (PV at end year 6)					0.84					
Additional benefit required (PV at end year 6)					2.80					
Summary										
Financing benefits (nominal)			1.67	1.67	-2.51	0.84	0.84			
Financing benefits (PV at end year 5)			2.08	1.93	-2.70	0.84	0.78			
Total financing benefits (PV at end year 5)						2.93				
Additional benefits required (nominal)			5.60	5.60	-8.40	2.80	2.80			
Additional benefits required (PV at end year 5)			6.96	6.47	-9.03	2.80	2.60			
Total additional benefits required (PV at end						9.80				
Total DB benefits (PV at end year 5)						12.73				
Realised incentive rate						32.62%				

Again the same data as used in Models 1 and 2 are used and the same ex–ante incentive rate of 32.6 per cent is chosen for illustrative purposes. The underspend from year 1 is now trued–up at the start of year 3 and so on leading to the year 5 underspend being trued–up at the start of year 7. The NSP now effectively only retains one year of financing benefits on a rolling basis through the regulatory period. In Model 3 the year 1 true–up is done at the start of year 3 in present value terms at the end of year 2, the year 2 true–up is done at the start of year 4 in present value terms at the end of year 3 and so on.

Converting the smaller financing benefits to present values terms at the end of year 5 for comparison with Model 2, the NSP has retained benefits of $2.9 million out to year 7. Converting the larger additional benefits required series to present value terms at the end of year 5, the NSP requires additional revenue of $9.8 million (delivered in a series of annual revenue requirement additions in years 3 through to 7) to achieve the specified ex–ante incentive rate.

The main difference between Models 2 and 3 is that the periodic true–up in Model 2 allows the financing benefit to make up most of the NSP's overall benefit whereas the lagged annual true–up in Model 3 requires most of the NSP benefit to come from additional allowances.

B Sample of contingent projects and indicative costs

Below are samples of transmission contingent projects and their anticipated values which were accepted by the AER in recent transmission regulatory determinations. These were considered as part of the Commission's analysis on establishing an appropriate threshold for distribution and transmission contingent projects.

Table B.1 Contingent projects and indicative costs

TNSP	Regulatory period	Project	Cost	Unit	Triggered
Powerlink	2012/13 to 2016/17	Galilee Basin connection shared network works	88.4	$m, 2011-12	No
		Moranbah area	54.9		No
		Bowen industrial estate	80.7		No
		Callide to Moura transmission line and Calvale transformer	50.8		No
		Gladstone state development area	115.7		No
		Ebenezer establishment	62.7		No
		QNI upgrade	60.6		No
		Western Downs to Columboola 275kV 3rd circuit	59.5		No
		Columboola to Wandoan South 275kV 3rd circuit	63.3		No
		Halys to Blackwall 500kV operating at 275kV,	148.9		No
		Halys to Western Downs, 3rd and 4th circuits, 500kV operating at 275kV	261.4		No
		Halys to Greenbank, 3rd and 4th circuits, 500kV operating at 275kV	149.2		No
Transend	2009/10 to 2013/14	Sheffield–George Town new transmission line	70	$m, 2007-08	No
		Burnie–Smithton new transmission line	88		No
		Sheffield–Farrell new transmission line	79		No
		Sheffield–Burnie new transmission line	52		No

TNSP	Regulatory period	Project	Cost	Unit	Triggered
		St Helens new 110/22 kV connection site	46		No
		Palmerston– Sheffield 220 kV transmission line augmentation	22		No
		Waddamana–Lindisfarne 220 kV transmission line second circuit	22		No
		Trevallyn Substation new 220/110 kV injection point	21		No
		Queenstown Substation security upgrade	11		No
TransGrid	2009/10 to 2013/14	Kemps Creek−Liverpool 330 kV line—undergrounding of all or part of the proposed connection	108	$m, 2007-08	No
		Hunter Valley–Central Coast 500 kV line	300		No
		Darlington−Balranald system upgrade 275 kV	51		No
		Yass to Wagga 500 kV double circuit transmission line	329		No
		Liddell−Tamworth 330 kV	163		No
		Tamworth−Armidale 330 kV line	130		No
		Bannaby−Yass reinforcement	45		No
		Williamsdale–Cooma 3rd circuit	40		No
		New 500/330 kV substation at Richmond Vale	80		No
		CBD and inner metropolitan area supply	342		No
		Gadara/Tumut load area support	54		No
		Orange 330/132 kV substation	47		No
		Victorian interconnector development	35		No
		QNI upgrade—line series compensation project	60		No

TNSP	Regulatory period	Project	Cost	Unit	Triggered
		Reactive support at seven sites	36		No
ElectraNet	2008/09 to 2012/13	Eyre Peninsula reinforcement	150	$m	No
		Riverland reinforcement	130		No
		Yorke Peninsula reinforcement	41		No
		South East reinforcement	33		No
		Bungama reinforcement	12		No
		Southern Suburbs reinforcement	16		No
		Playford (Davenport) to Leigh Creek 132 kV transmission line	11[477]		
		Fleurieu Peninsula reinforcement	65		No
		Murray Mallee reinforcement	34		No
		Munno Para reinforcement	26		Approved $39.3 ($m, 2007/08) on 11 March 2011
		Lucindale West reinforcement	17		No
		Western Suburbs reinforcement	15		No
		Tailem Bend to Tungkillo reinforcement	41		No
		Parafield Gardens West	14		No
		Para – Brinkworth – Davenport 275 kV transmission lines	12		No
		Heywood interconnection capacity upgrade	80		No
		Northern transmission reinforcement	75		No
		Adelaide CBD line works component	105		Approved $131.38 ($m, nominal) on 1 November

477 Five per cent of the MAR is $11m, which makes this amount the cost threshold for ElectraNet's contingent projects.

TNSP	Regulatory period	Project	Cost	Unit	Triggered
					2009
		Transformer ballistic proofing	17		No

Source: AER final decision, ElectraNet transmission determination 2008-09 to 2012-13, 11 April 2008, p. 61; AER final decision, Powerlink transmission determination 2012-13 to 2016-17, April 2012, p. 45; AER final decision, Transend transmission determination 2009-10 to 2013-14, 28 April 2009, pp. 55-57; AER final decision, TransGrid transmission determination 2009-10 to 2013-14, 28 April 2009, p. 43.