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20 September 2006

Dr John Tamblyn
Chair
Australian Energy Market Commission
PO Box H166
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Dear Dr Tamblyn

AER Supplementary Submission on Draft Chapter 6 Rules

The AER provided a detailed submission in response to the AEMC Draft Chapter 6 Revenue Rules on 15 September 2006.

The submission lodged on behalf of the Electricity Transmission Network Owners Forum (ETNOF) dated 11 September 2006 proposes a number of changes to the provisions of the Draft Rules relating to the approval of forecast opex and capex. These changes are set out in an attachment to the submission prepared by Gilbert+Tobin.

The AER believes that the changes proposed by the ETNOF fundamentally modify the principles for the formulation and assessment of opex and capex forecasts. In so doing, the proposed changes potentially amend the balance of the regulatory regime outlined in the Draft Rules.

Further, the ETNOF submission identifies a series of omissions and flaws which it argues justifies these amendments to the Draft Rules. These omissions and flaws do not exist.

Given the importance of these issues, it is necessary for the AER to submit the attached supplementary submission.

Please contact me if you wish to discuss the issues raised in the supplementary submission.

Yours sincerely



Steve Edwell
Chairman

APPROVAL OF FORECAST OPEX AND CAPEX

The submission filed on behalf of the Electricity Transmission Network Owners Forum (“ETNOF”) dated 11 September 2006 proposes a number of changes to the provisions of the Draft Rules relating to the approval of forecast opex and capex. These changes are set out in an attachment to the submission prepared for the ETNOF by Gilbert+Tobin.

The AER is concerned that this submission recommends a series of amendments based on a number of alleged omissions and flaws in the Draft Rules that do not in fact exist. The changes proposed by the ETNOF would:

- fundamentally modify the principles for the formulation and assessment of opex and capex forecasts;
- reduce the transparency and predictability of regulatory decisions; and
- render the process for making a final decision unworkable.

The ETNOF submission identifies a series of concerns which, it is submitted, justify amendments to the Draft Rules. Each of these concerns is addressed in turn.

1. No requirement for the AER to make a determination

It is suggested that the Draft Rules do not in fact require the AER to make a determination on whether the TNSP has proposed reasonable estimates of required opex and capex. This is not correct.

Clauses 6A.12.1(b) and 6A.13.1(b) provide that the AER’s draft and final decisions:

“must be made in accordance with, and must comply with, the relevant requirements of rule 6A.14.”

Clauses 6A.14.1(2)(i) and 3(i) provide that:

“A draft decision under rule 6A.12 or a final decision under rule 6A.13 is a decision by the *AER*:
...

(2) in which the *AER* determines:

- (i) whether the total of the forecast capital expenditure for the *regulatory control period* as set out in the current *Revenue Proposal* is a reasonable estimate of the *Transmission Network Service Provider’s* required capital expenditure for the *regulatory control period* taking into account the matters referred to in clause 6A.6.7(b)(3);
- ...

(3) in which the *AER* determines:

- (i) whether the total of the forecast operating expenditure for the *regulatory control period* as set out in the current *Revenue Proposal* is a reasonable estimate of the *Transmission Network Service Provider’s* required operating expenditure for the *regulatory control period* taking into account the matters referred to in clause 6A.6.6(b)(2)”.

If the AER makes a draft or final decision that does not contain a determination on whether the forecasts of required opex or capex are reasonable estimates the AER will, contrary to clauses 6A.6.12.1(b) and 6A.13.1(b), fail to make its decision in accordance with the relevant requirements of clause 6A.14. Plainly the AER is bound by these provisions to make such a determination. No further change is required to the Draft Rules to achieve this outcome.

2. Matters to be taken into account in assessing a TNSP's forecasts

It is suggested that the matters to be taken into account under clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) are unclear and tend to confuse the criteria as to what is reasonable with evidentiary matters.

This submission is based on a misunderstanding of the regime proposed by the AEMC in the Draft Rules. The Draft Rules separately specify:

- (a) the cost drivers that must be met by the TNSP's opex and capex allowance (clauses 6A.6.6(a) and 6A.6.7(a)); and
- (b) the criteria to be applied and the matters that must be taken into account in deciding whether the forecasts are reasonable estimates of the opex and capex required to meet those cost drivers (clauses 6A.6.6(b)(2) and 6A.6.7(b)(3)).

The changes proposed by the ETNOF fundamentally modify the nature of the AER's assessment, by turning these cost drivers into the assessment criteria and by reducing clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) to matters that the AER *may* take into account. This reduces the transparency and predictability of the regulatory process, since the AER now has a wide range of matters that it may (or may not) choose to consider in any given process.

Clauses 6A.6.6(a) and 6A.6.7(a) require a Revenue Proposal to include forecasts of the opex and capex that *the TNSP* considers reasonably necessary to do the things specified in those clauses. Through these provisions, the Draft Rules provide guidance to both the TNSP and the regulator about the purposes for which opex and capex forecasts must be developed. One of the grounds under which the AER must assess these forecasts is whether they are reasonable estimates of the opex and capex required by the TNSP to do these things (clauses 6A.6.6(b)(2) and 6A.6.7(b)(3)).

Obviously, the two sets of provisions are closely related. The AER must determine whether the TNSP has proposed a reasonable estimate of its required opex and capex. Clauses 6A.6.6(a) and 6A.6.7(a) set out what that opex and capex is required for. If the AER does not approve the forecasts proposed by the TNSP, it must substitute its own estimate of the forecast opex or capex reasonably required for those same purposes (clause 6A.13.2(b)(3)).

The ETNOF proposal substantially modifies the arrangements set out in the Draft Rules by turning the cost drivers into the criteria, and relegating the matters in clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) to matters that the AER may (or may not) consider. These amendments are not appropriate and should not be adopted.

3. Non-compliance with submission guidelines

The AER agrees that trivial non-compliance with the submission guidelines should not automatically result in rejection of a TNSP's opex or capex forecast. The AER would not administer this provision in such a strict manner.¹ While the AER does not believe any amendment is required, it has proposed an amendment that would, if necessary, put this beyond doubt.

The amendment proposed by the ETNOF goes further than rectifying the alleged defect in the Draft Rules. The ETNOF proposes an amendment that allows the AER to "have regard to" any instance of non-compliance with the submission guidelines. This has now been relegated to a matter that the AER can consider in deciding what weight to give to the TNSP's proposal. A TNSP can, in effect, ignore a requirement of the submission guidelines with little consequence if the TNSP is unconcerned about the reduced weight that *might* be given that part of its application.

If the process envisaged by the AEMC is to work, the Rules must contain effective incentives to encourage timely compliance with the submission guidelines required by those Rules. The regime for merits review is not an adequate substitute for the Rules in this respect. While substantial compliance with the submission guidelines should be sufficient, the Rules must continue to provide clear incentives to ensure compliance. The appropriate balance will be struck if the following amendments are made to the Draft Rules.

1. Amend clause 6A.6.6(b)(3) to read as follows:

"the operating expenditure forecasts and the information provided in relation to those forecasts substantially comply with the requirements of the *submission guidelines* made under clause 6A.10.2"

2. Amend clause 6A.6.7(b)(4) to read as follows:

"the capital expenditure forecasts and the information provided in relation to those forecasts substantially comply with the requirements of the *submission guidelines* made under clause 6A.10.2".

4. Publication of analysis prior to final decision

It is argued by the ETNOF that, in making its final decision, the AER should only be allowed to rely on its own analysis if it has published that analysis *prior* to making the final decision. The AER is strongly opposed to this amendment. It will create opportunities for gaming and delay that could render it impossible to make a transparent and well reasoned decision in the time allowed under the Rules.

The Draft Rules require the AER to make a draft decision. The AER must invite and consider submissions in response to that draft decision before making its final decision. Procedural fairness and good process naturally require the AER to publish its analysis in that draft decision. Transparency and the merits review process also require that the AER publishes its analysis as part of the reasons for its final decision.

¹ eg. see *National Electricity Law*, Schedule 2, cl 9(1); *Adams v Lambert* [2006] HCA 10.

However, requiring the AER to publish all of the analysis it proposes to put into its final decision, *before that decision is made*, will render the process of making a final decision unworkable. It creates conditions in which the AER is caught in a cycle where it must publish its analysis of a submission, prompting a further submission which may require the AER to publish further analysis, prompting a further submission, and so on. This is simply not a feasible way to make a decision where time is limited and the deadline is inflexible.

This problem is exacerbated by clause 6A.12.3 of the Draft Rules, under which the TNSP is not limited to making a submission, but could substantially revise its proposal. This means that the AER could, in effect, be required to prepare a second draft decision. In an earlier submission, the AER has argued that this provision needs to be modified to limit this.

The AER's final decision is only reached once the AER has set out its draft conclusions and considered all submissions in response. It sets out the AER's final position on all issues that must be addressed. While the general principles of administrative law will still require the AER to afford procedural fairness to a TNSP in making its final decision, these principles do not typically require interested parties to be given a further opportunity to respond to every conclusion before it is finally made.² No such requirement should be imported into the Rules.

5. Matters to be taken into account by the AER in forming its own estimate

If the AER determines that the TNSP's opex or capex forecast is not a reasonable estimate, the Draft Rules require the AER to develop and substitute its own forecast. It is submitted that the AER is only required to take into account the "criteria" in clause 6A.6.6(a) or 6A.6.7(a), and not the information provided by the TNSP in or with its Revenue Proposal or the matters in clause 6A.6.6(b)(2) or 6A.6.7(b)(3).

This is not correct. As noted above, clause 6A.13.2(b)(3) provides that if the AER rejects a TNSP's opex or capex forecast, it must substitute its own forecast of the opex or capex required for the purposes specified in clauses 6A.6.6(a) or 6A.6.7(a). Clauses 6A.12.1(b) and 6A.13.1(b) provide that the AER's draft and final decisions "must be made in accordance with, and must comply with, the relevant requirements of rule 6A.14."

Clauses 6A.14.1(2)(ii) and 3(ii) provide that:

"A draft decision under rule 6A.12 or a final decision under rule 6A.13 is a decision by the *AER*:

...

(2) in which the *AER* determines:

...

(ii) (if the *AER* determines that it is not a reasonable estimate), its reasons for that determination and an estimate of the provider's required capital expenditure for the *regulatory control period* that **the *AER* considers to be reasonable, taking into account the matters referred to in clause 6A.6.7(b)(3)**, together with the reasons for that conclusion;

...

² *Commissioner for the Australian Capital Territory Revenue v Alphaone Pty Ltd* (1994) 49 FCR 576, 590-592.

(3) in which the *AER* determines:

- (i) if the *AER* determines that it is not a reasonable estimate, its reasons for that determination and an estimate of the provider's required operating expenditure for the *regulatory control period* **that the *AER* considers to be reasonable taking into account the matters referred to in clause 6A.6.6(b)(2)**, together with the reasons for that conclusion" (**emphasis added**).

The "matters referred to" in clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) include "the information included in or accompanying the Revenue Proposal" and "submissions received in the course of consulting on the Revenue Proposal".

It is clear that, if the *AER* rejects a TNSP's opex or capex forecast, it must take into account the TNSP's proposal and supporting information (and each other matter set out in clauses 6A.6.6(b)(2) and 6A.6.7(b)(3)) in developing its own estimate of the opex or capex reasonably required for the purposes specified in clauses 6A.6.6(a) and 6A.6.7(a). No further amendment to the Draft Rules is required.

6. Other changes

(a) prudence

The ETNOF has proposed the inclusion of a 'prudence' test in clause 6A.6.6(a) and 6A.6.7(a). This amendment is not appropriate. These provisions require the TNSP to produce an estimate of the opex and capex that *the TNSP* (not a hypothetical 'prudent' TNSP) believes is reasonably required for the purposes specified in those clauses.

(b) the need to comply with regulatory obligations

The ETNOF has proposed deleting clauses 6A.6.6(b)(2)(ii) and 6A.6.7(b)(3)(ii). This amendment is not appropriate. Section 16(2)(a) of the NEL requires the *AER* to ensure a TNSP is provided with a reasonable opportunity to recover the efficient costs of complying with regulatory obligations (also see s 35(3)(a) of the NEL). It is appropriate that this is identified as a matter the *AER* must take into account.

(c) arm's length arrangements

The ETNOF has proposed amending clauses 6A.6.6(b)(2)(vi) and 6A.6.7(b)(3)(vi) to refer to arrangements that are 'not' arm's length, rather than arrangements that 'might not be'. This amendment is not appropriate. It suggests that the *AER* must prove that an arrangement is not 'arm's length' before it can give any weight to this matter. Experience shows that such arrangements are rarely (if ever) this clear cut. The meaning of the term "arm's length" is itself open to debate. Obviously the strength of the evidence before the *AER* will affect the weight properly given to this matter. The *AER*'s judgment on whether such an arrangement might exist will be a finding of fact reviewable by the Tribunal, as will the weight given to such an arrangement.³ If the AEMC wants to see such arrangements taken into account by the *AER* it is important that it does not set the bar any higher.

³ *ACCC v Australian Competition Tribunal* [2006] FCAFC 83 at [171]-[178].

Conclusion

The amendments proposed by the ETNOF are not justified as they are based on omissions and flaws that do not exist. The AEMC set out a number of objectives for these provisions in its Draft Rule Determination,⁴ including the following:

- responsibility for deciding whether forecasts are reasonable estimates rests with the AER;
- the decision making process and criteria are intended to provide the AER with sufficient powers and safeguards to be able to achieve regulatory outcomes that are not overly distorted by strategic behaviour on the part of TNSPs;
- the AER should be able to deal with exaggerated proposals and TNSPs are likely to see the benefits of well supported forecasts, as opposed to ambit claims and poorly supported forecasts;
- the criteria specified in the Draft Rules are relevant and appropriate.

The amendments proposed by the ETNOF are not consistent with these objectives. The proposed amendments do not merely give effect to the AEMC's intention. That has already been done in the Draft Rules. Instead, these amendments:

- weaken the AER's ability to properly scrutinise opex and capex forecasts;
- reduce the guidance provided to TNSP's in developing these forecasts;
- reduce the transparency and consistency of the AER's review process; and
- render the final decision process unworkable.

These proposed amendments detract from the achievement of the NEM objective and should not be adopted by the AEMC in the final Rules.

⁴ Australian Energy Market Commission (AEMC), *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, pp 52-53, 55.