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To: The COAG Energy Council Secretariat
COAG Energy Council Senior Committee of Officials

By email (energycouncil@environment.gov.au)

Australian Energy Regulator's submission on the draft legislation to create a binding rate of return instrument

We welcome the opportunity to provide input on the draft legislation to implement a binding rate of return instrument. Overall, we support the policy objectives of the reforms as captured in the SCO bulletin.[1]

> The amendments will implement a binding instrument that sets out a single approach to the calculation of rate of return parameters for all network businesses; and which is developed through a single, industry-wide process every four years. These new arrangements will enhance regulatory certainty for regulated businesses and the regulator. They will also reduce the regulatory burden for all stakeholders in terms of the time and costs involved in debating rate of return issues.

Our view is that the draft legislation appropriately gives effect to those policy objectives. In particular, we support the clear focus on the national electricity and gas objectives and the revenue and pricing principles (RPPs) as the decision making tests that a rate of return instrument should satisfy.

In this submission, we highlight features of the draft legislation that are important to the overall objectives including:

- the importance of a binding instrument
- the appropriate decision-making tests
- re-opening of the binding instrument
- the benefits of a less prescriptive process.

We have also included comments from our consumer challenge panel subpanel 16 as an appendix to this submission. That sub-panel is tasked to provide consumer-focussed advice to

1 COAG Energy Council Senior Committee of Officials, *Bulletin—Consultation on binding rate of return amendments*, March 2018, p. 1.

the AER as part of the ongoing review that, under the draft legislation, will become the first binding instrument.

The policy intent of a binding instrument

In order to provide predictability and certainty to stakeholders through implementation of a binding instrument, it is our view that:

- The process of making the instrument should allow discretion to have regard to all relevant sources of evidence and to consult extensively on an approach to estimating the rate of return; then

- Once the binding instrument is made, it should apply automatically in all determinations from the time it is made until the review of the next guideline is complete. Other than in exceptional circumstances the guideline should not be re-opened. As discussed later in this submission, it is also our view that these circumstances are best assessed by reference to achievement of the NEO and NGO.

We are satisfied that the draft legislation effectively implements these intentions. We recommend that these core aspects of the drafting is important and should be maintained in its current form.

Transitional timing

We recognise that immediate application of a binding instrument on its completion is likely to fall within ongoing determination processes for some of the regulated networks in each regulatory cycle. In particular, the transitional provisions for the making of the first binding instrument (NEL part 15 s 29(1)) require that the first binding instrument, made in December 2018, will apply immediately to service providers whose final decisions are due to be published in April 2019. In our view, this is appropriate because:

- Under the rules framework that currently prevails it is likely that we would apply the findings of our current review to those networks with decisions due in April 2019. Under the current rules we set the rate of return in each of our regulatory determinations. In making these decisions, we have regard to the current (2013) non-binding guideline, but service providers or the AER may justify departures from the 2013 guideline.[2] If our ongoing review identifies reasons to depart from the non-binding guideline then we would be likely to do so in making the final determinations for the affected networks.

- The first binding instrument will be determined through a sector wide process and extensive consultation with all stakeholders, including the affected networks. While proposals in those determinations may not reflect a finalised binding instrument, the networks will be in a position to refer to the draft binding instrument and subsequent

[2] This transitional feature was a consequence of the AEMC's 2016 rule change to extend the deadline for the review of the 2013 guideline from December 2016 to December 2018. See: AEMC, *Rule determination–National Electricity Amendment (Rate of Return Guidelines Review) Rule 2016 and National Gas Amendment (Rate of Return Guidelines Review) Rule 2016*, October 2016.

analysis or consultations in making their revised proposals. The affected networks are also able to fully participate in the process of making the binding instrument.

The appropriate decision-making tests

In our view, the draft legislation establishes appropriate and sufficient decision-making tests that we and the ERA must follow when making a binding rate of return instrument:

- Under proposed s 18J(1) of the NEL and proposed s 30E(1) of the NGL, we may only make a rate of return decision that we are satisfied will promote the national electricity and gas objectives to the greatest extent.
- In doing so, we must have regard to the revenue and pricing principles (NEL s18L(a) and NGL s30G(a)).
- Correspondingly, the draft legislation removes subordinate decision-making tests currently set out in the NER and NGR. In our view, this:
    - appropriately emphasises that the NEO, NGO and RPPs are the critical objectives of the regulatory rate of return
    - maintains the requirements necessary to achieve estimates of the rate of return which are in the long-term interests of consumers of gas and electricity.

By design, the national gas and electricity rules frameworks must promote achievement of the national electricity and gas objectives. A framework that removes subordinate detail should therefore not preclude us from adopting any of the approaches that are permissible under the current rules framework. Removal of this additional detail also mitigates the risk that unintended interpretations of subordinate drafting results in a scenario where consistency with that unintended interpretation takes precedence over the key objectives of the framework. It has been our experience that this commonly occurs where multiple layers of decision-making tests are specified.

It is our view that the revenue and pricing principles within the NEL and NGL convey the appropriate guidance specific to estimation of the rate of return, including that:

- regulated network service providers should be provided with the reasonable opportunity to recover at least the efficient costs incurred in providing regulated services or complying with regulatory obligations (NEL cl. 7A(2); NGL cl. 24(2))
- efficient investment in, provision of and use of regulated services (NEL cl. 7A(3); NGL cl. 24(3)) and the economic risks and costs of over or under investment (NEL cl. 7A(6); NGL cl. 24(6)) in or over or under utilisation of a regulated network (NEL cl. 7A(7); NGL cl. 24(7)).
- a price or charge for a network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the service to which that price or charge relates (NEL cl. 7A(5); NGL cl. 24(5))
- regard should be had to the economic risks and costs of under or over investment by a regulation network service provider (NEL cl. 7A(6); NGL cl. 24(6))

These provisions overlap substantially with the current allowed rate of return objective which requires that:

> The allowed rate of return objective is that the rate of return for a Distribution Network Service Provider is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the Distribution Network Service Provider in respect of the provision of standard control services (the allowed rate of return objective). (emphasis added)

We consider the decision-making tests set out in the draft legislation satisfactorily capture all of the requirements necessary to achieve estimates of the rate of return which promote the long term interests of consumers of gas and electricity. Where there are subtle differences in terminology, our view is that these differences should be removed to reiterate the primacy of the national gas and electricity objectives and the revenue and pricing principles which, in our view, are sufficient.

Re-opening a binding instrument

Allowing scope to re-open a binding instrument presents a range of policy challenges. In particular:

- to some extent, it compromises the certainty created by the binding instrument because the potential timing and outcome of a remade instrument cannot be predicted
- a decision on whether or not to re-open the instrument is likely to be a complex decision subject to the exercise of judgement
- the presence of the re-opener provision could encourage persistent submissions calling for the binding instrument to be re-opened. This could contribute to a level of regulatory burden similar to the current framework; compromising the policy intent of the binding instrument.

For these reasons, our view is that a re-opener provision should not be included.

However, if a re-opener is to be included for exceptional and unforeseen circumstances then the re-opener provision should only be triggered by reference to a high threshold. As discussed in the following section, our view is that the threshold included in the draft legislation is suitably high.

The threshold for re-opening an instrument early

The draft legislation (NEL subsection 4 s. 18U(3); NGL subsection 4 s. 30P(3)) specifies that we may open the rate of return guideline ahead of schedule only where we determine it is necessary to support achievement of the NEO and NGO to the greatest degree.

In our view, this is a high threshold for re-opening the binding instrument ahead of schedule. We support the imposition of a high threshold such that early review of the binding instrument should only occur in rare and exceptional circumstances. We hold this view because:

- We have received consistent feedback from investors that the predictability and certainty outweighs the value of flexibility in determination of the rate of return. For example, in our first concurrent expert session in the ongoing review, the representative expert on behalf of our investor reference group observed that:[3]

> An environment of confidence should mean both transparency and predictability, both in process and in outcome. From my perspective accurate and effective decisions are what we all should be striving for but we don't want to fall into a trap of looking for false precision. We shouldn't be looking for the intellectual theory of the day, therefore there should be significant benefit in making any changes because there is a real cost of continuing to change things.

- It is our experience that it is possibly to specify an approach to estimating the rate of return which is adaptable to changing market circumstances::
  - The variation in market parameters which change frequently (such as the risk free rate) can be accommodated by an automatically updating formula with the option of contingency outcomes for foreseeable events
  - Our estimation of other parameters has been sufficiently stable that they could be set over a four year period without the need for variation.

The review process in the event of a re-opened binding instrument

Where circumstances arise justifying the re-opening of a binding instrument ahead of schedule, our view is that those same circumstances may require the flexibility for an expedited review of the binding instrument. We recognise the importance of clarity within the binding legislation about the level and type of consultation stakeholders can expect in a review. However, we recommend that it is preferable to allow for flexibility in the review process where, in our view, an expedited review is necessary for achievement of the national electricity and gas objectives.

The benefits of less prescription

We support the consultation processes set out in the draft legislation (NEL s. 18M–18P; NGL s. 30I–30L) and, as part of our ongoing review, have already implemented a consumer reference group and concurrent expert evidence sessions. We are currently working towards appointing an independent panel to review our draft instrument. However, these processes are new. It is likely that, as part of this and future reviews, we and stakeholders may find aspects of these consultation steps to be more or less useful, or to find potential improvements in the processes.

3 AER, *Review of the rate of return guideline- Concurrent expert evidence session 1, 15 March 2018*, p. 7 transcript lines 7–12.

For these reasons, we recommend that it is in the long term interests of stakeholders to define less procedural detail in the legislation which may impede the ongoing improvement of the consultation process.

Yours sincerely

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on behalf of

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