

fee payable by the GOC.<sup>182</sup>

### **Difference between benchmark return on debt and actual cost of debt**

In its submission, the EURCC states that the Commission has an incorrect understanding of the relationship between the regulatory return of debt allowance that sets the charges that energy users pay, and, the service providers' calculation of their actual cost of debt.

Since state-owned service providers are able to borrow funds at interest rates based on the credit rating of their respective state or territory government, a debt guarantee fee/competitive neutrality fee aims to ensure that the service providers are subject to a rate of interest or cost of debt based on their own credit rating. The fee represents an extra charge to make up the difference between the interest paid by the service provider and the amount they would have paid in the absence of a government guarantee. Therefore, under the current rules, the return on debt estimate does not need to account for any charges associated with these fees as the return on debt is estimated on the basis of a benchmark service provider with a standalone credit rating.

### **Resource allocation distortions**

The EURCC states that it disagrees with the Commission's view that competitive neutrality considerations include resource allocation distortions in input as well as output markets. The EURCC states that resource allocation distortions can only occur if the state governments charge fees to some government departments (or corporatised businesses that it owns) but not to others.

The EURCC notes the example where the Queensland and NSW governments charge government debt guarantee fees for the debt that they provide to their service providers, but they do not charge the same fee for the debt that they provide to their health, education or housing departments. It claims that this type of distortion would lead the governments to prefer lending to their service providers rather than to, for example, their health, education or housing departments, since they get a fee from the loans it makes to the former but not the latter. It concludes that any debt government guarantee fees may therefore encourage misallocation of resources – more lending for networks at the expense of hospitals, schools and roads, etc. On this reasoning, the EURCC states that the Commission's conclusion that service providers should be subjected to debt neutrality fees is therefore in contradiction.

Debt raised by service providers to fund capex is an input into the network services they produce as the output for users. The current application of government debt guarantee fees ensures that service providers apply a commercial discipline to their borrowing to fund any capex requirements. Absent the government debt guarantee fees, the service providers would now be facing an artificially lower rate of return than

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<sup>182</sup> Queensland Treasury, *Queensland Government, Code of Practice for Government Owned Corporations' Financial Arrangements*, August 2009, available at: <http://www.ogoc.qld.gov.au/goc-policies/code-of-practice-gocs-fin-arr.pdf>.

other private sector service providers seeking to raise funds in the same capital markets.

Faced with an artificially lower rate of return, the service provider may view capex solutions as comparatively lower cost to non-network solutions. This is because a lower rate of return implies that non-network solutions involving operating expenditure costs such as labour costs and non-asset solutions are now comparatively less attractive. Clearly, artificial distortion on the efficiency of capex means that resources in the input markets are no longer being used at least cost, thus causing allocative inefficiency.

Lack of competitive neutrality on debt costs would not only result in resource allocation distortions between different types of inputs for network solutions and non-network solutions, it would also have an impact on other businesses. State-owned electricity service providers can be considered to be in competition with:

- the gas sector which is a fuel of choice; and
- other electricity networks when large consumers are considering where to locate new factories, offices etc.

This point was also made by the NSW Treasury in their submission to the rule change requests.<sup>183</sup>

Any network over-investment by service providers caused by an artificially lower rate of return allowance would have flow on effects for gas networks since they compete with electricity as a fuel of choice in states such as Queensland and, to a lesser extent, in NSW. If service providers are required to charge comparatively lower prices to their consumers due to lower rate of return, it could lead consumers to switch any discretionary consumption of gas to electricity. Over the longer term, not only would this cause inefficient consumption of electricity, it would also impact on the competitiveness of the gas networks.

Having an artificially lower rate of return allowance can also impact on the competitiveness of other investor-owned service providers or third party suppliers of alternative control services that compete with state-owned service providers. If the state-owned service provider's rate of return did not reflect market based rates and they did not face any commercial discipline, then they could effectively outbid their competitors for projects.

In the Commission's view, it is arguably more likely that reducing the rate of return for state-owned service providers in the way proposed by the EURCC could lead to under-investment by the relevant service providers because the state governments may choose to restrict their access to debt capital. Whatever the reaction of the state government, it appears likely to lead to some distortions in behaviour.

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<sup>183</sup> NSW Treasury, Consultation Paper submission, 23 December 2011, p. 7.

Contrary to the EURCC's view, applying competitive neutrality to the cost of borrowing of state-owned service providers ensures that the businesses recognise the efficient cost of debt and therefore minimise any resource allocation distortions.

On the second issue raised by the EURCC with respect to government guarantee fees encouraging misallocation of resources between service providers and other public goods providers such as hospitals, education and housing departments, etc, it is important to recognise that government debt has an opportunity cost.

The government has a finite borrowing capacity at particular prices for debt, and it must make allocation decisions on the debt it can raise in the capital markets. If the government did not apply debt management discipline to the service providers, the debt it would raise for them must compete with other government services such as hospitals, roads and public housing that do not operate to the same degree on a commercial basis.

The debt guarantee fee represents the opportunity cost of the government borrowing on behalf of the service providers. Borrowing will impact on investment in other public goods such as roads, hospitals and schools. As service providers pass on their costs to their consumers, the government guarantee fees act to allow compensation for the opportunity cost to taxpayers for providing the cheaper lending.

If governments were to provide debt to service providers at AAA credit rating without charging a neutrality fee, it would mean an effective subsidy from taxpayers. The guarantee fees aim to allow the best deployment of funds for the governments and value to taxpayers.

In any event, the Commission considers that how the jurisdictional governments choose to prioritise their funding is a public policy matter that is beyond the scope of the NER to address.

### **Geographical market distortions**

The EURCC put forward two reasons for its disagreement with the Commission's view about potential geographical market distortions that could arise through their proposal on different cost of debt for state-owned service providers. The EURCC claims that:

- (i) with regard to generators, since they do not pay for the use of the transmission (or distribution) systems they will not be impacted by any difference between the charges levied by privately-owned or state-owned service provider; and
- (ii) with regard to end users, the Commission has shown that privately-owned service providers already have lower network charges than state-owned networks. If there is a prospect of inefficient end-user relocation due to price differences between networks then, if anything, reducing the charges of state-owned service providers will help to address this problem, not exacerbate it, as the Commission has concluded.

The Commission remains concerned that circumstances where service providers operating in different geographic regions would be required to set prices that are differentiated by ownership rather than by reference to the underlying economic costs of providing those services could create distortions. There could over time potentially be an artificial incentive for overinvestment in generation and network capacity in the lower price regions, along with under-investment in demand-side initiatives.

### **Sale or divestiture of state-owned service providers**

The EURCC disagrees with the Commission's view that its proposal would effectively preclude any state government from selling or divesting its service provider. It rejects that view on the basis that:

- privately-owned service providers already charge considerably less than state-owned service providers. If state-owned service providers are privatised, their owners will deliver higher levels of investment and operating efficiency than has occurred under state ownership; and
- if state governments were not able to derive such high profits and fees from their service providers, they are more likely to want to sell them.

More generally, the EURCC states that it is inappropriate for the Commission to be mindful of the impact of rule change proposals in terms of the propensity for state governments to privatise service providers. According to their view, such a consideration is not contemplated in the NEO.

The rule proposed by the EURCC attempts to differentiate efficient cost recovery depending on who the shareholder is. If such a rule was made, it risks distorting the incentives of efficient capital financing structures of state-owned 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.

In the Commission's interpretation of the NEO, the efficiency of a service provider should be based on how well they can respond to the incentives provided by the regulatory framework.

### **Taxes versus equity ownership**

The EURCC suggests that the dividends paid to the state governments as the shareholder and the taxation payments paid to the state governments as the taxing authority should be added together when considering the effective returns (or profits) that state governments are receiving from their service providers.

This issue was considered in the directions paper, and the Commission does not agree with the EURCC's contention. As SFG noted, when taxation revenues are included in this calculation, the resulting estimate of the return on equity would be disproportionate to the risk that is borne by the state governments as the



shareholder.<sup>184</sup> SFG has already advised the Commission that the return received by governments as a shareholder (as dividends) should be compared with the risk borne as a shareholder and taxation revenues received as the taxing authority should have no part in this comparison.<sup>185</sup> The Commission remains satisfied that SFG's view is appropriate.

#### **Use of the Commonwealth Government's approach for the guarantee scheme for ADIs**

The EURCC suggests that a potential way forward for estimating return on debt for state-owned service providers could be based on the approach adopted by the Commonwealth Government in relation the benchmark for the Guarantee Scheme for Large Deposits and Wholesale Funding Australian Deposit-taking Institutions (ADIs).

While the details of how this might precisely work in the context of its rule change proposal have not been provided in its submission, the EURCC appears to be suggesting that the rules could be made to require establishing a benchmark basis points spread based on some defined credit rating and debt tenor that would be explicitly added to the state-owned service providers' return on debt allowance, as observed through the yields on their respective state treasury bonds.

It is unclear how this approach would materially differ to the current approach where the government debt guarantee fees are levied on each service provider by their state treasuries based on cost of debt estimates of a service provider with a stand-alone credit rating (which is different to the state's credit rating). State treasuries generally obtain independent market cost of debt estimates based on stand-alone credit ratings for each of the service providers they finance, and determine the guarantee fee based on the difference between the actual cost of debt incurred for the service provider and notional market-based cost of debt derived from market surveys. For example, in its submission the QTC has stated that it obtains DRP estimates from market surveys for BBB+ rated companies with varying debt maturities to calculate the competitive neutrality fee to apply to the service providers it finances.<sup>186</sup> The BBB+ credit rating is what the AER has used for the benchmark market-based return on debt estimate to date.

It might be the case that stakeholders such as the EURCC do not fully understand how jurisdictional governments determine the debt guarantee fees for their service providers. It may be useful if there was a more transparent process through which the fees were levied.

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<sup>184</sup> SFG Consulting, *Preliminary analysis of rule change proposals*, Report for the AEMC, 27 February 2012, p. 36.

<sup>185</sup> *Id.*, p. 37.

<sup>186</sup> QTC, Directions Paper submission, 16 April 2012, Appendix B.

## 7.5 Draft rule

This section covers return on debt aspects of the new rate of return framework that the Commission proposes to adopt, which was discussed in the previous chapter of this draft determination.

This section should be read in conjunction with the section in the previous chapter that discussed the draft rule for the overall rate of return framework, including how the Commission intends the proposed draft rule to be interpreted. It is particularly important to note that the proposed draft rule places a requirement on the regulator to determine a rate of return that meets the overall allowed rate of return objective. It is the Commission's view that 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 proposed draft 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.

The Commission would also welcome comments on whether the draft rule on return on debt achieves the Commission's intended objective.

### 7.5.1 Estimating return on debt

The Commission has not mandated any particular approach to estimating the return on debt in the draft rule. Instead, the draft 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 draft rule describes these three options to make it clear that all of them are available to the regulator if it considers they best meet the overall allowed rate of return objective. The Commission accepts that it could also have chosen not to describe any approaches, but it considers that there is a benefit of certainty in stating clearly the range of available options.

The Commission intends that the regulator (and the service provider in its regulatory proposal or access arrangement proposal) have the discretion to propose an approach 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. The 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 their proposed approach is better than the approach proposed by the regulator in the guidelines.

The proposed draft 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 proposed draft rule provides the regulator with substantial 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 draft 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. The specific factors identified in the draft rule are:

- the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient service provider and the estimated return on debt;

- the impact on consumers, including due to any impact on the return on equity of a benchmark efficient service provider;
- the incentive effects of inefficiently delaying or bringing forward capex; and
- the impact of changing the methodology for determining the return on debt across regulatory periods.

The Commission explains below the types of issues that the regulator is be expected to consider when having regard to each of these factors.

**Likelihood of differences between the cost of servicing debt of a benchmark efficient service provider and the estimated return on debt**

The Commission intends that there is consideration of the extent to which the methodology used is commensurate with the financing and hedging strategy of the benchmark efficient service provider. This means that there should be consideration of the extent to which the methodology matches the funding costs expected to be incurred by a benchmark efficient service provider over the regulatory period, having regard to the debt arrangements the benchmark efficient service provider is likely to already have in place. This matching is based on the benchmark efficient service provider but, this benchmark could vary with the nature of regulated entities and their efficient funding and hedging strategies. Further, the length of any proposed averaging period would need to be considered alongside the benchmark service provider's borrowing profile.

**Impact on consumers, including the impact on the return on equity**

The Commission considers it essential that the effect on consumers is considered. Perhaps the most direct way in which consumers could benefit from the use of a historical trailing averaging period would be if this reduced the required return on equity because a benchmark efficient service provider's refinancing risks had been reduced through the particular method that was adopted for estimating the return on debt. To the extent that a methodology allows the overall risk to equity holders to be reduced in a measurable way by reducing the cash flow volatility of equity returns the regulator might be expected, all other things being equal, to be positively disposed towards it.

Quantifying the impact may be difficult in many cases, but the Commission would expect that the position of different types of service providers could be considered. For example, large single asset service providers might argue they face high refinancing risks from a prevailing rate approach, such that moving to a historical averaging approach would provide a net decrease in risk to equity holders, and consequentially a net benefit to consumers. Similarly, the Commission would expect that some service providers would argue that their equity investors would be worse off under any historical trailing average approach and therefore consumers would be better off with retention of the prevailing rate approach in their case.

### **Incentive effects of inefficiently delaying or bringing forward capex**

This factor requires the regulator to consider the impact of its proposed approach on incentives to accelerate or delay capex in ways that are inefficient and hence run counter to the NEO, the NGO and the RPP. A distortion to investment incentives can arise where there is a significant mismatch between the cost of debt under the regulatory determination and the actual costs of debt in the market. For example, if the return on debt under the regulatory determination is lower than the cost of debt in the market then service providers may under invest relative to an efficient amount of investment.

### **Impact from changing the methodology across regulatory periods**

The Commission considers that when there is a proposed change in methodology for estimating the return on debt, consideration should be given to the consequences for investment incentives arising from a change in methodology. In particular, 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 factor is intended to promote consideration of whether these issues would arise and how best to address them.

## 8 Capex and opex allowances and factors

### Summary

- Since publication of the directions paper the Commission has done further work to address the problems raised by the AER, being inappropriate constraints in the NER on its powers to interrogate and amend capex and opex proposals.
- The Commission has analysed further evidence provided to it of the drivers of prices, which indicate that both the rate of return and expenditure allowances have been significant factors contributing to higher network charges. However it is not possible to tell from this if any expenditure allowances to date 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 to assess this forecast and should consider all material and submissions before it. Further work confirms that the practices of the AER pursuant to Chapter 6A conform to good regulatory practice when compared with other regulators in Australia and overseas, and the Commission's view is that Chapter 6A 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.
- There are however some areas for improvement in the NER to clarify the approach and remove ambiguities.
- Benchmarking is a critical exercise in assessing the efficiency of a NSP's capex and opex forecasts. It should take into account differences in the environments of the different NSPs.
- The AER should be required to undertake annual benchmarking of NSPs. Among other things, this will improve the ability of consumers to participate in the regulatory process.
- It is appropriate that the methodology or methodologies for determining expenditure forecasts be set in advance of the NSP preparing its regulatory proposal. It should be included as part of the framework and approach paper.

This chapter sets out the Commission's considerations in respect of capex and opex allowances, and capex and opex factors. Section 8.1 sets out further thinking on

whether the problem raised by the AER exists, that is, whether the NER inappropriately constrain the AER in respect of the way it can interrogate and amend NSP's capex and opex forecasts. Having dealt with the problem, section 8.2 describes the original intent of Chapters 6 and 6A of the NER and sets out some changes to the NER to clarify ambiguities and increase clarity. Section 8.3 addresses other issues relating to capex and opex allowances, and section 8.4 deals with capex and opex factors.

## **8.1 Do the NER inappropriately constrain the AER regarding capex and opex allowances?**

### **8.1.1 Introduction**

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.<sup>187</sup> While there are legitimate reasons for increases in network charges, it states these constraints are also driving up network charges.<sup>188</sup>

The AEMC commenced its analysis in the directions paper by examining evidence for these problems in AER regulatory determinations and comments of the Australian Competition Tribunal. It considered submissions provided by stakeholders, and engaged two consultants, Professors Littlechild and Yarrow, to undertake further analysis. Following this analysis, the Commission did not come to a conclusion as to whether constraints in the NER were driving up network charges. In order to consider the matter in greater depth, the Commission called for further evidence from stakeholders of a problem and engaged consultants to reconsider the original intent behind Chapter 6A of the NER.

### **8.1.2 Submissions**

The AER and the ENA have both provided lengthy submissions in response to the AEMC's request for further information about the drivers for rising network costs. Both assess how much lower revenues would have been had key variables not been allowed to increase from the previous regulatory period. These include capex, opex and the rate of return.<sup>189</sup> The relative significance of rate of return and capex differs between the two submissions but both found they were significant. The ENA submission also includes a critique of a 2011 Bruce Mountain paper referred to in the directions paper.<sup>190</sup> The AER's submission includes examples of how it claimed it had been constrained in setting capex and opex allowances.<sup>191</sup>

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

188 *Id.*, p. 6.

189 ENA, Directions Paper submission, 16 April 2012, p. 10; and AER, Directions Paper submission, 2 May 2012, Appendix 1, p. 9.

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

191 AER, Directions Paper submission, 2 May 2012, Appendix 2.

In terms of other stakeholders, Ausgrid provides a detailed submission explaining its recent increases in investment.<sup>192</sup> Other NSPs and representative groups provide additional detail of drivers for price increases.<sup>193</sup> Consumers groups highlight declining affordability and also the fact that the growth in the RAB has been outstripping growth in demand, new connections or length of network in recent times.<sup>194</sup> Perceived inefficiency of state-owned NSPs is also a focus of consumer group submissions.<sup>195</sup>

### 8.1.3 Analysis

This section sets out the Commission's further consideration of whether there is a problem with the NER in respect of capex and opex allowances in the way claimed by the AER.

#### Rising network charges

At the start of the rule change process, a number of assertions were made by stakeholders about rising network charges. For example, the AER claimed that a significant proportion of recent rises in electricity prices can be attributed to increases in network charges, and that one factor driving up network charges has been the need for capex and opex.<sup>196</sup> In order to understand the context of the problems, the Commission sought more detail on the drivers for increases in network charges and any link between these increases and the NER.

As described above, in response to this request some stakeholders have provided detailed research and analysis. Submissions from these stakeholders demonstrate that a number of factors have been causing increasing network charges. There is no doubt that capex and opex allowances have increased from previous periods, but the significance of the capex and opex increases in comparison to increases in other factors - and in particular the rate of return - is not clear. According to the ENA, rate of return increases are at least as significant a driver of network costs as increases in capex and opex.<sup>197</sup> On the other hand, according to the AER, which conducted a similar type of analysis to the ENA though excluding adjustments as a result of Tribunal decisions, the increase in the forecast capex from the previous period is a more significant factor than rate of return increases.<sup>198</sup> Had the AER included the effect of the Tribunal decisions

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<sup>192</sup> Ausgrid, Directions Paper submission, 16 April 2012, p. 4.

<sup>193</sup> See for example ENERGEX, Directions Paper submission, 16 April 2012, p. 2; ESAA, Directions Paper submission, 24 April 2012, p. 4.

<sup>194</sup> Consumer Action Law Centre, Directions Paper submission, 16 April 2012, pp. 2-3; EUAA, Directions Paper submission, 16 April 2012, pp. 2-11; Ethnic Communities Council of NSW, Directions Paper submission, 16 April 2012, p. 2; and UnitingCare Australia, Directions Paper submission, 9 May 2012, pp. 23-31.

<sup>195</sup> EUAA, Directions Paper submission, 16 April 2012, p. 8.

<sup>196</sup> AER, Rule change request, Part A, 29 September 2011, pp. 5-6.

<sup>197</sup> Compare ENA, Directions Paper submission, Attachment C, 16 April 2012, p. 9 (Figure 3.1) and p. 11 (Figure 3.2).

<sup>198</sup> AER, Directions Paper submission, 2 May 2012, Appendix 1, p. 4 (Figure 1.3).



its results may not have been too dissimilar to those of the ENA. Either way, the submissions provide important clarity to the problem. Increases in capex and opex are driving up network charges, but rate of return increases are also contributing to this.

However, the mere fact of increases, or even significant increases, in capex and opex allowances for a NSP from one period to the next does not of itself demonstrate a deficiency in the NER. The increased capex and opex may be required to meet the objectives in the NER. To demonstrate a deficiency, it is necessary to show that these increases were more than what was needed to satisfy the requirements of the NER, including the requirement that capex and opex allowances should reasonably reflect efficient costs. Little evidence has been provided relating to the efficiency of the expenditure allowances determined by the AER. The ENA's analysis of this efficiency identifies the main drivers of capex and opex increases, such as replacement capex, for key NSPs. The ENA then shows that the AER or its consultant came to the view at the most recent reset for the NSP that the expenditure proposed for that category was efficient.<sup>199</sup> Ausgrid has provided a higher level of detail on the need for increased investment.<sup>200</sup>

The directions paper referred to a report by Bruce Mountain in 2011 which offered a way of assessing the efficiency of DNSPs' expenditure.<sup>201</sup> This sort of analysis could have been used by stakeholders in responding to the directions paper to show whether capex or opex allowances were efficient. The ENA has, however, provided a critique of the Mountain report in Attachment B to its submission. This critique appears to take the view that the Mountain report is too simplistic in its analysis to be robust. For example, Mountain should have used energy distributed and peak demand as part of his composite scale variable, in addition to customer numbers.<sup>202</sup> The Commission accepts that it may be possible to undertake a more sophisticated analysis, taking into account more of the "exogenous" reasons for differences between the levels of capex and opex required by each NSP. This does not invalidate the overall approach taken in Mountain's report, though. While there may be some shortcomings in Mountain's report, no analysis has been provided which would challenge Mountain's conclusion that the average privately-owned DNSP is more efficient than the average state-owned DNSP. With a greater use of benchmarking, perhaps using the approach suggested in Bruce Mountain's report, it may have been easier for the AER to identify inefficiencies in previous expenditure forecasts or allowances.

In conclusion, the analysis presented in submissions by stakeholders provides important context about rising network charges but does not confirm that expenditure allowances to date have been inefficient, or that there are in fact problems with the NER in this area. The AER analysis of specific constraints and the report commissioned by the AEMC comparing the original intent with other jurisdictions is more useful in this regard. These are discussed further below.

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199 ENA, Directions Paper submission, 16 April 2012, pp. 12-13.

200 Ausgrid, Directions Paper submission, 16 April 2012, Attachment A, section 3.

201 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 25.

202 ENA, Directions Paper submission, Attachment B, 16 April 2012, p. 7.

## AER evidence of constraints applying

Appendix 2 of the AER's submission provides evidence that the AER claims shows that the capex and opex allowed by the AER in its previous decisions may have been higher than efficient on the basis that the AER was constrained in its ability to replace a NSP's forecast with a lower amount. The AER refers to two of its regulatory determinations for Ergon Energy as examples. The first relates to corporation initiated augmentation (CIA) capex. The AER claims that it could not establish the CIA capex proposed by the NSP was inefficient but its substituted CIA capex was limited by the NSP's proposal, such as by having to use an 18 month deferral assumption.<sup>203</sup> In the other example, relating to customer initiated capital works (CICW), there was disagreement between the AER and Ergon Energy over the methodology for forecasting CICW. The AER claims that it was constrained by the NER to focus on the methodology rather than being free to establish its own efficient estimate.<sup>204</sup>

In each example the AER states it was limited to the approach Ergon Energy took to capex. It appears that each time the constraint was based on clause 6.12.3(f), which is discussed further below. 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 in the two examples described above the capex allowance may have been higher than was efficient, it is not clear this was due to a deficiency in the NER. Had the AER been able to provide benchmarking analysis that the Ergon Energy capex allowance was high relative to other NSPs this would have provided clarity on whether the allowance was, in fact, efficient.

## The Brattle report

The Brattle report considers 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. Here regulatory practice refers to the approach regulators use to determine expenditure allowances, such as the analytical techniques employed. In order to understand what good regulatory practice may be, Brattle looked at regulatory practices in seven jurisdictions in Australia and overseas which adopt incentive-based economic regulation. In considering these other jurisdictions the AEMC asked Brattle also to consider whether there are any "background factors" which might explain any differences observed in these other jurisdictions.

In addition to the AER, Brattle considered the regulatory approaches in Great Britain, New Zealand, New South Wales, Western Australia, Ontario and Rhode Island.<sup>205</sup> Brattle considered how the relevant regulators review capex and opex forecasts, and described the extent to which the practice in each jurisdiction is driven by rules or guidelines. Using the analysis of these different regimes, Brattle formed a conclusion

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<sup>203</sup> AER, Directions Paper submission, 2 May 2012, Appendix 2, p. 3.

<sup>204</sup> Id., p. 5.

<sup>205</sup> 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.

on best practice regarding approaches to setting allowances as part of incentive-based regulation. Following on from this, it sets out some observations and recommendations, including how the NER could be improved. Many of these observations and recommendations are used as support for the approach the Commission has taken in sections 8.2 and 8.3 below.

It is important to note that there are some clear differences between the jurisdictions chosen in terms of regulatory structures and institutional arrangements. For example, in NSW NSPs are state-owned, whereas in Great Britain they are privately-owned.<sup>206</sup> The AER does not have to assess the prudence of past capex, while the ERA, for example, does do this. Many North American regulators take a backward-looking approach to setting prices however Brattle chose Ontario and Rhode Island due to their use of forecasting.<sup>207</sup> There is much less prescription in Great Britain around how Ofgem must exercise discretion in respect of capex and opex allowances by comparison to the NER.<sup>208</sup>

In terms of the actual practices that regulators adopt when assessing capex and opex forecasts under incentive-based regulation, Brattle does not identify any fundamental differences between the approach of the AER and the practices of regulators in the other jurisdictions. It notes that in respect of assessments of capex and opex forecasts, while the level of prescription in the rules differs among jurisdictions, the regulators operating under 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.<sup>209</sup> Rules may affect the weight put on the results of different analysis, but Brattle is not able to determine this conclusively.<sup>210</sup> On the basis of Brattle's conclusion, the Commission's view is 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 makes 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 cannot 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 cannot see any reason to justify clause 6.12.3(f) in distribution given that there is no equivalent clause in Chapter 6A.

In general, Brattle states that the regulator should always be free to develop its own analytical method, though the rules might provide guidance in the form of principles. There are some additional tools which could be used to improve how capex/opex

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206 Id, paragraph 26.

207 Id., paragraph 75.

208 Id., paragraph 12.

209 Id., paragraphs 13, 30 and 31.

210 Id., paragraph 33.

allowances are set, such as the use of output measures and a "menu" approach to forecasts.<sup>211</sup>

Other matters considered by Brattle include the following:

- rejecting or adjusting the NSP's proposal - in some jurisdictions the rules require the regulator first to test whether the NSP's forecast is reasonable before making an adjustment, whereas in others the regulator's goal is simply to set a forecast, though Brattle considers that this apparent distinction is not a helpful way of characterising what regulators actually do in practice;<sup>212</sup>
- importance of good information - as discussed further below, it is critical that the regulator has good information;<sup>213</sup>
- analytical tools - each regulator develops its own tools to address issues that arise;<sup>214</sup>
- interaction between NSP and regulator - these interactions tend to be similar in all jurisdictions considered, though in some there is additional "senior-level" interaction;<sup>215</sup> and
- consumer engagement - there does not appear to be a common approach to consumer engagement, but it would appear that other regulators engage with consumers or consumer representatives more than the AER does, both on a formal and informal basis.

Finally, Brattle highlights the importance of good data for setting expenditure allowances at the right level. Some regulators in other jurisdictions have put considerable effort into improving the data they collect. This includes annual data collection outside the determination process, and regular interaction with NSPs to ensure that the data collection process is operating effectively.<sup>216</sup>

## Conclusion

On the basis of the analysis in the directions paper and this draft rule determination, the Commission forms 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;

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<sup>211</sup> Id., paragraphs 41-45.

<sup>212</sup> Id., paragraph 15.

<sup>213</sup> Id., paragraph 16.

<sup>214</sup> Id., paragraphs 17 and 43.

<sup>215</sup> Id., paragraph 23.

<sup>216</sup> Id., paragraph 44.

- 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.

## 8.2 Clarifying the rules regarding capex and opex allowances

### 8.2.1 Introduction

In the directions paper the Commission indicated an initial view that the overall approach to setting expenditure allowances in the NER remains valid but that changes so that this approach is better reflected in the rules, and to improve clarity generally, may be warranted.

### 8.2.2 Submissions

The AER's submission maintains its position that it is constrained in the way it can substitute its own estimate for NSP expenditure forecasts, though it states fewer constraints apply in respect of the AER's ability to reject a proposal for being too high.<sup>217</sup> For example, it states when it seeks to substitute its own estimate it is limited to addressing only those elements of a proposal which do not meet the expenditure criteria. The AER has provided more material on the incentives on NSPs to over-forecast and exacerbate information asymmetries.<sup>218</sup> The AER states that a better approach than the current NER would be for it to be free to replace a NSP's forecast with its better estimate, though it would need to justify this on the basis of the information before it, as well as principles in the NEL.<sup>219</sup>

NSPs maintain their position that the AER is not constrained by the NER and no changes are necessary in respect of the setting of expenditure allowances.<sup>220</sup> The ENA states that the way the NER has been applied has not been inconsistent with the approach set out in the AEMC's Chapter 6A rule determination. Consumer groups support the AER's proposal and believe that its experience is sufficient reason for concern; it should be given the benefit of the doubt in these matters. The onus of proof should be shifted away from the AER to the NSPs, who must be required to justify

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<sup>217</sup> AER, Directions Paper submission, 2 May 2012, p. 2.

<sup>218</sup> *Id.*, p. 5.

<sup>219</sup> *Id.*, p. 11.

<sup>220</sup> ENA, Directions Paper submission, 16 April 2012, p. 23.

their forecasts. In general if there is no detriment to consumers in clarifying the NER in the way required by the AER then this should occur.<sup>221</sup>

The Victorian Department of Primary Industries (Vic DPI) also supports changing the NER to clarify the AER's powers, and states that it does not think the AER's proposed changes would give it unconstrained powers.<sup>222</sup> The SA DMITRE suggests changing the propose-respond approach, with its claimed presumption in favour of investment, to receive-determine which gives the AER more discretion.<sup>223</sup> IPART expresses concern about unnecessary price increases and supports the AER's proposal to allow it to adopt its best estimate of efficient costs.<sup>224</sup>

In respect of benchmarking, NSPs continue to seek the retention of the reference to the "circumstances of the NSP" in the NER so that the AER takes these circumstances into account.<sup>225</sup>

### 8.2.3 Analysis

#### Confirming the approach to capex and opex allowances

In section 8.1 above, the conclusion was that while the Chapter 6A approach remains broadly consistent with good regulatory practice, it could be enhanced in some areas, and there could also be changes to Chapters 6 and 6A of the NER so that they better reflect that approach. The changes to the NER are discussed further below.

The original intent behind Chapter 6A was initially described by the AEMC in 2006.<sup>226</sup> Set out below is a further clarification of what that intent is regarding capex and opex allowances.

The NSP's proposal is necessarily the procedural starting point for the AER to determine a capex or opex allowance.<sup>227</sup> 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,

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<sup>221</sup> CUAC, Directions Paper submission, 16 April 2012, pp. 3-4; Consumer Action Law Centre, Directions Paper submission, 16 April 2012, pp. 3-4; EUAA, Directions Paper submission, 16 April 2012, pp. 18-19; TEC, Directions Paper submission, 17 April 2012, p. 4.

<sup>222</sup> Vic DPI, Directions Paper submission, 16 April 2012, pp. 2-4.

<sup>223</sup> SA DMITRE, Directions Paper submission, 5 May 2012, p. 3.

<sup>224</sup> IPART, Directions Paper submission, 16 April 2012, pp. 5-6.

<sup>225</sup> ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 44; Grid Australia, Directions Paper submission, 16 April 2012, p. 6.

<sup>226</sup> AEMC, Economic Regulation of Transmission Services, Rule Determination, 16 November 2006.

<sup>227</sup> 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.

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 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 each of capex or 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".<sup>228</sup> 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.<sup>229</sup> 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.<sup>230</sup> The obligation to accept a reasonable proposal, discussed above, 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.<sup>231</sup> 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.

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228 *Id.*, p. 52.

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

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

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

## Changes to clarify and remove ambiguity in the NER

The description of the approach above confirms that the NER is drafted appropriately in many areas. With the exception of benchmarking, discussed further below, 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.<sup>232</sup> The AER, 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. As described above, the criteria also do not impose an inappropriate evidentiary burden.

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.<sup>233</sup> 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.

The analytical techniques the AER may use are not limited by the capex/opex criteria. This is appropriate, as Brattle has indicated.<sup>234</sup> On the other hand, 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 an NSP's proposal beyond what is necessary to result in a reasonable allowance. NSPs state 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.<sup>235</sup> On the other hand, the AER has interpreted these provisions as imposing a much greater constraint on it.<sup>236</sup> The Brattle Group has 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.”<sup>237</sup>

The Commission has determined it should be clear clause 6.12.3(f) does not apply to capex and opex allowances. The guidance provided by this clause, as described above, such as requiring the AER to take into account the NSP's proposal, would be achieved

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<sup>232</sup> The Brattle Group, *Framework for assessing capex and opex forecasts as part of a “building blocks” approach to revenue/price determinations*, June 2012, paragraph 42.

<sup>233</sup> *Id.*, paragraph 14.

<sup>234</sup> *Id.*, paragraph 17.

<sup>235</sup> ENA, Consultation Paper submission, Attachment C, 8 December 2011, p. 11; though note Ausgrid, Consultation Paper submission, 8 December 2011, p. 17.

<sup>236</sup> AER, Directions Paper submission, 2 May 2012, p. 11 and Appendix 2 generally.

<sup>237</sup> 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.



by other provisions anyway, and this clause represents a difference between Chapters 6 and 6A for which there is no substantive explanation. 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 has proposed that the criterion relating to demand forecasts and cost inputs<sup>238</sup> is less important than the first two criteria and should be moved to the capex and opex factors. In the directions paper the Commission took the initial view that the significance of demand forecasts and cost inputs is such that they should remain in the capex and opex criteria.<sup>239</sup> The AER has since proposed that these could be moved to the capex and opex objectives.<sup>240</sup> This would, however, 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 remains of the view that this criterion should remain where it is.

The Commission shares the view expressed by The Brattle Group that there could be greater harmony between Chapters 6 and 6A.<sup>241</sup> 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,<sup>242</sup> 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 has therefore determined to adjust Chapter 6A to remove the rule requirement for the AER to prepare submission guidelines; any information the AER would have required to be provided through submission guidelines can be required to be provided through a regulatory information instrument.

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<sup>238</sup> See for example, clause 6.5.7(c)(3).

<sup>239</sup> AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 33.

<sup>240</sup> AER, Directions Paper submission, 2 May 2012, p. 16.

<sup>241</sup> The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraphs 21, 35 and 41.

<sup>242</sup> See chapter 10.

## Benchmarking

The Commission views benchmarking as a critical exercise in assessing the efficiency of a NSP and determining the appropriate capex or opex allowance. Any benchmarking exercise must take into account differences in the environments of the different NSPs. The directions paper sought to explore further with stakeholders the circumstances that benchmarking should take into account with a view to determining whether these circumstances should be clarified in the NER. Submissions from stakeholders in response indicate consistency in terms of the circumstances that are considered relevant to benchmarking.<sup>243</sup> Broadly, the factors that would be taken into account are exogenous - being factors outside the control of the NSP - such as the age of the network, and topography. Endogenous factors, such as the nature of ownership or previous managerial decisions, should not generally be taken into account. Having considered the possible circumstances raised in submissions, the Commission shares the view expressed in the joint submission of ETSA, CitiPower and Powercor that the variety of circumstances are such that it would be difficult for the AEMC to set these out in the NER in a comprehensive way.<sup>244</sup>

Instead, the reference to "circumstances of the relevant NSP" should be removed from the capex and opex criteria. 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. Given the importance of benchmarking in determining the capex or opex allowance, any inappropriate constraints on the AER under the NER in undertaking a benchmarking exercise should be removed.

In response to the concerns Grid Australia raised about other consequences of the removal of the reference to "circumstances of the relevant NSP", these appear to be unfounded.<sup>245</sup> Outside of benchmarking, it is hard to see how the manner in which a NSP accounts for its costs could be affected by this clause. The clause only relates to the total costs a prudent operator would require to achieve the objectives and the way a NSP accounts for its costs is irrelevant. The AER should not be able to control such processes through this clause.

### 8.2.4 Guidance on draft rule

#### Changes to clarify and remove ambiguity in the NER

Section 8.2.3 has recommended some changes to clarify and remove ambiguity in respect of the AER's powers to consider and, if necessary, amend, expenditure forecasts. As described above, however, the existing rules in this area remain appropriate. Importantly, the existing rules operate at a high level and, with the

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<sup>243</sup> AER, Directions Paper submission, 2 May 2012, p. 9; ENA, Directions Paper submission, 16 April 2012, p. 23; Jemena, Directions Paper submission, 16 April 2012, p. 13; and ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 43.

<sup>244</sup> ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 45.

<sup>245</sup> Grid Australia, Directions Paper submission, 16 April 2012, p. 6

possible exception of clause 6.12.3(f), which is discussed further below, do not prescribe in detail how the AER must go about assessing expenditure forecasts. The Commission is of the view that the best outcomes will be achieved if the NER do not attempt to describe too closely what the AER must do in this area, and instead leave it with the discretion to determine, based on its own experience and judgment, the right level of capex and opex allowance.

Under the existing rules, 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 existing 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.

In respect of clause 6.12.3(f), the Commission has determined to amend this so it is made clear that it does not apply to the AER's decisions in respect of substituted capex or opex allowances under Chapter 6 of the NER. This means that, when the AER replaces a NSP's forecast with the AER's substitute amount or value, the NER do not require that the substitute is determined on the basis of the NSP's proposal and amended from that basis only to the extent necessary to be approved. 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 themselves no longer prescribe it.

### **Benchmarking**

The draft rule gives the AER discretion as to how and when it undertakes benchmarking. 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 overground 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.

Endogenous factors not to be taken into account may include:

- the nature of ownership of the NSP;

- quality of management; and
- financial decisions.

## 8.3 Other issues

### 8.3.1 Introduction

In the course of consulting on the rule change requests, other options for dealing with the original problems raised by the AER have been identified. Some of these are described in this section.

### 8.3.2 Submissions

The AER proposes 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.<sup>246</sup> At present, the AER has had 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. There are practical problems in using a regulatory information instrument to specify the AER's model.

Instead, the AER seeks to consult on 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 the model in the framework and approach paper, including any departures it has made from the model.

Another issue that has been identified is that the opex/capex objective to maintain the quality, reliability, safety and security of the distribution/transmission system and the regulated services provided by it may perpetuate a higher standard than is necessary based on past service and reliability standards. In general, stakeholders are supportive of clarifying the word "maintains" in the capex and opex objectives so that forecasts are better aligned with applicable service and reliability standards.<sup>247</sup> The Vic DPI states that since Victoria does not have jurisdictional reliability standards the capex and opex objectives should not be stated in these terms.<sup>248</sup>

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<sup>246</sup> AER, Consultation Paper submission, 12 December 2011, p. 12.

<sup>247</sup> AER, Directions Paper submission, 2 May 2012, p. 17; ENA, Directions Paper submission, 16 April 2012, p. 24.

<sup>248</sup> Vic DPI, Directions Paper submission, 16 April 2012, p. 4.

### 8.3.3 Analysis

#### Annual benchmarking reports

Benchmarking has been discussed in section 8.2.3 above. As well as informing the AER's consideration of capex and opex allowances, benchmarking analysis undertaken by the AER can be of benefit to consumers.

A key issue that has arisen in the context of this rule change process is the ability of stakeholders, and in particular consumers, to participate actively in regulatory determinations. A number of changes have been made to the NEL to improve consumer participation, and if consumer groups were better resourced it would likely lead to significantly improved consumer engagement. Other changes have been made to encourage NSPs to engage more with consumers prior to submitting their regulatory proposals.

In addition to this, changes need to be made to improve the information available to consumers, including adequate and relative - in the sense of comparing NSPs- information about network performance. Having access to this would assist consumers both in informal interaction with NSPs as well as engaging in the formal regulatory process and merits reviews. The Commission considers 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 easily understood by consumers. This would set out the relative efficiencies of distribution and transmission NSPs, taking into account the exogenous factors that distinguish them.

These reports would also 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 addition, the capex and opex factors have been amended to allow the AER to consider any relevant annual benchmarking report when assessing a capex or opex forecast.

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.

In order to undertake an annual benchmarking exercise, the AER should use the best information available to it. This may involve using the information gathering powers it has under the NEL, such as regulatory information instruments. Alternatively, the AER may collect information on a voluntary basis or else use information it has collected in other processes, such as regulatory determinations. Brattle has underlined the importance of annual data collection outside of the regulatory determination process,

and notes the effort other regulators have put into doing this.<sup>249</sup> It appears the AER does not undertake information gathering and benchmarking to the same extent as many other regulators.

One reason for the AER's lack of information gathering could relate to the powers it has. Among other things, 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 NEL may also provide the AER with greater powers in this respect; the AEMC has 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.

### **Engagement on the expenditure model**

In this rule change process, the Commission encourages NSPs, the AER and other stakeholders to engage more often, on a more informal basis, and outside of the regulatory determination process. In most cases, it is not possible to mandate this engagement through new rules, and instead it should occur through a change in approach of the bodies mentioned. Some provisions of the draft rule have been designed to facilitate this. They include a new capex/opex factor which requires the AER to take it into account the extent to which expenditure forecasts include expenditure to address the concerns of consumers that have been identified in the course of consumer engagement, and certain changes proposed in chapter 10 such as an extension to the time frame for the regulatory determination process.

Nevertheless, it may be appropriate to mandate consultation between the AER and the NSP on some specific matters. One such area is expenditure models. The expenditure models to be used to prepare capex and opex forecasts are a critical part of a NSP's proposal. The AER has stated that NSPs are not restricted in the methodologies they may use to prepare their expenditure forecasts, and that the AER remains unaware of the methodology or methodologies a NSP decides to use until the regulatory proposal is submitted.<sup>250</sup> The AER has proposed that the methodologies for preparing expenditure could be included as part of the framework and approach paper stage.

It is hard to see any disadvantages in an approach which encourages 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 generally and, more critically, if the AER prefers a different methodology it may take the NSP some time to re-run its calculations, 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. This includes Chapter 6A (transmission), in which a framework and approach paper step should be added to the

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<sup>249</sup> 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.

<sup>250</sup> AER, *Directions Paper submission*, 2 May 2012, p. 12.

regulatory process. Importantly, for flexibility, there should be no restriction on a NSP also including in its regulatory proposal expenditure forecasts generated using methodologies other than those specified in the framework and approach paper, as long as the framework and approach paper methodology or methodologies are also used.

### **Capex and opex objectives**

In the directions paper, the Commission noted the concern raised by the AER that 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.<sup>251</sup> In general, submissions were not opposed to the capex and opex objectives being clarified to recognise greater flexibility for the AER in this regard.<sup>252</sup>

On further consideration, a change to these objectives would be outside the scope of this rule change. While the AER raised the issue, it indicated that it had chosen not to proceed with the issue in its rule change proposal, and did not propose a rule change as a result.<sup>253</sup> This issue was also considered by the Commission as part of the NSW workstream of the Review of Distribution Reliability Standards and Outcomes, where it was suggested that this issue should be resolved through a separate rule change proposal.<sup>254</sup>

### **Menu regulation**

The directions paper raised the concept of incentive schemes that would encourage more accurate forecasting by rewarding companies for making forecasts that turn out to be correct.<sup>255</sup> In Great Britain, an example of this type of scheme is menu regulation. On further consideration, a scheme such as menu regulation is likely to require a wide range of changes to the way expenditure forecasts are provided which are not warranted at this stage based on the evidence provided. Menu regulation is discussed further at section 9.5.1 below.

#### **8.3.4 Guidance on draft rule**

### **Engagement on the expenditure model**

The draft rule requires the AER to develop a standard methodology for preparing expenditure forecasts. This overall methodology may be comprised a number of

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<sup>251</sup> AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 30.

<sup>252</sup> See for example, ENA, Directions Paper submission, 16 April 2012, p. 24.

<sup>253</sup> AER, Rule change request, Part B, 29 September 2011, p. 33.

<sup>254</sup> AEMC, *Review of Distribution Reliability Outcomes and Standards*, Draft Report - NSW workstream, 8 June 2012, p. 101.

<sup>255</sup> AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 29.

approaches. For example, it may include the "repex" model that the AER used in the recent Victorian distribution regulatory determinations for replacement capex, and a different approach for augmentation capex. NSPs would have the chance to make submissions on this model when the AER consults on it. There is no obligation that the same standard methodology be used for transmission and distribution, but given the similarities between TNSPs and DNSPs it seems likely this would be the same. There may, however, be specific NSPs for whom the standard model is not appropriate, perhaps due to size or location. The AER would have the ability in its framework and approach paper, which is also consulted on, to identify if the NSP is required to use the standard methodology, or if not, what alternative methodology should be used. In preparing its proposal, the NSP could use different methodologies but at least one of these would have to be the methodology specified in the framework and approach paper.

### **Annual benchmarking reports**

The Commission notes above that the AER may need additional information gathering powers under the NEL to produce robust annual benchmarking reports. To the extent that a lack of information gathering powers has affected the ability of the AER to undertake annual benchmarking, the AER could raise this in the reports.

## **8.4 Capex and opex factors**

### **8.4.1 Introduction**

The AER must 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.

### **8.4.2 Submissions**

The AER maintains its position from its rule change request. In particular, while seeking that the "procedural" factors should be moved to the procedural provisions of Chapters 6 and 6A, it sees no need for a rule that replicates the procedural fairness requirement to publish analysis relied on in a decision.<sup>256</sup> It continues to press removing from the capex and opex criteria the reference to demand forecasts and cost inputs.

The ENA is very concerned that there must be an obligation on the AER to make available to a NSP in advance all material on which the AER intends to rely in its final decision.<sup>257</sup> It does however accept that the capex and opex factors should not be exhaustive.<sup>258</sup> In terms of moving the procedural factors, the ENA is concerned that

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<sup>256</sup> AER, Directions Paper submission, 2 May 2012, p. 15.

<sup>257</sup> ENA, Directions Paper submission, 16 April 2012, p. 41.

<sup>258</sup> *Id.*, p. 39.



this would affect the weight that would be placed on them.<sup>259</sup> The joint submission of ETSA, CitiPower and Powercor, on the other hand, does not object to moving the procedural factors.<sup>260</sup>

### 8.4.3 Analysis

#### Process-related changes

The Commission maintains its position 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.<sup>261</sup> 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 certain facts or data. As such, they sit better with the other procedural provisions, such as clause 6.11.1. It is noted that ETSA, CitiPower and Powercor, in their joint submission, support this approach.<sup>262</sup>

The ENA does not support moving these factors.<sup>263</sup> This is partly because they are fundamental elements of the AER's decision and partly for legal reasons. The Commission shares the view that these should be fundamental components of the AER's decision, but does not see the shift to the procedural provisions as altering this approach. The ENA raises 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.<sup>264</sup> To accommodate this, the draft rule adopts the "have regard to" wording for all three factors.

The Commission has considered further the views it presented in the directions paper regarding the requirement on the AER to consider analysis it has published.<sup>265</sup> It acknowledges the challenges in using merits review to test analysis published with a final regulatory determination, and notes that the NEL requires that the AER inform NSPs of material issues under consideration.<sup>266</sup> However, the Commission maintains the position that because the length of time the AER has to reach a final regulatory determination is fixed there could be times when it is too difficult for the AER to consult on analysis prior to the final regulatory determination. To balance the time constraints against the need for scrutiny of new material, the draft rule requires the

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259 Id., p. 39.

260 ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 46.

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

262 ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 46.

263 ENA, Directions Paper submission, Attachment F, 16 April 2012, p. 24.

264 Id., p. 68.

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

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

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. The obligation on the AER under section 16(1)(b) of the NEL is also relevant; as with any provision of the NEL, this has priority over related provisions of the NEL to the extent of any inconsistency.

### **Non process-related changes**

In respect of the other proposed changes to the capex and opex factors, the Commission maintains 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 maintains its position from the directions paper that the AER is not at present limited to the factors set out in the NEL. At the same time, however, different clauses in the NEL take an inconsistent approach to whether additional wording needs to be added to confirm that factors are exhaustive, and this could lead to ambiguity. To clarify this, an additional factor has been 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, there is also included in the draft rule 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 have been made to the capex and opex factors. 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.<sup>267</sup> The Commission agrees with this and has removed the reference to labour costs and broadened the scope of the incentive schemes covered. In addition, consequential amendments have been made to the capex and opex factors in Chapter 6 to recognise the addition of the contingent projects regime.

As discussed above, the factor relating to benchmarking<sup>268</sup> has been expanded to refer to the annual benchmarking reports.

Finally, a factor has been 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 factor, 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

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<sup>267</sup> AER, Rule change request, Part B, 29 September 2011, p. 34.

<sup>268</sup> See for example clause 6.5.7(e)(4).

be satisfied that a proposal reflects efficient costs. A similar approach is taken in Great Britain by Ofwat in respect of water regulation.<sup>269</sup>

#### **8.4.4 Guidance on draft rule**

##### **Process-related changes**

The "best endeavours" clause in the draft 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 draft 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.

##### **Non process-related changes**

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 new capex and opex factor that clarifies that the AER may consider additional factors, any additional factor must be notified to the relevant NSP prior to the NSP submitting its proposal.

In respect of the new factor 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 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.

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<sup>269</sup> See for example Ofwat, *Involving customers in price setting - Ofwat's customer engagement policy statement*, April 2011, p. 21.

## 9 Capex incentives

### Summary

- The AER raised concerns about what it considers to be incentives for NSPs to spend more than their capex allowances and recommended the introduction of a requirement in the NER that only 60 per cent of any expenditure incurred by a NSP above its capex allowance would be rolled into the RAB.
- The Commission does not agree that capex incentives in the NER provide incentives for NSPs to spend more than their allowance. However, it has identified issues in relation to incentives to seek efficiencies and a lack of supervision of capex above the allowance. Further analysis of actual capex by NSPs has also identified that there are legitimate circumstances in which expenditure above capex allowances could occur.
- The Commission's approach to addressing these problems is 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, having regard to an overall capex objective which is consistent with the NEO and RPP. These tools are:
  - capex sharing schemes to be designed by the AER;
  - efficiency reviews of past capex, including the ability to preclude inefficient expenditure from being rolled into the RAB. However, any exclusion will be limited 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 will describe what the capex incentive regime, as a whole, should aim to achieve. The AER will also 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 the NSP spent more than its allowance, the AER will have the discretion to preclude expenditure from being rolled into the RAB to the extent that expenditure comprises:
  - inefficient related party margins; or

- opex which was capitalised as a result of within period changes to the NSP's capitalisation policies.

## 9.1 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 period. In the regulatory determination, the AER determines to either approve this forecast or not approve it and replace it with its own forecast<sup>270</sup> which then becomes the allowance. This allowance is the basis of an incentive for a NSP. If a NSP spends more than its allowance it is required to bear the costs<sup>271</sup> of this expenditure above the allowance for the remainder of the period. Conversely, if it spends less than its allowance it retains the benefit for the rest of the period.

The AER claims that the NER provide an incentive for NSPs to spend more than efficient levels of capex for a regulatory period.<sup>272</sup> 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 proposes to prescribe in the rules an adjustment to the RAB roll forward<sup>273</sup> such that a NSP could only recover 60 per cent of the cost of any over expenditure (the 60/40 sharing mechanism).<sup>274</sup> It also requests 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 considers 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 period.<sup>275</sup>

The Commission does 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

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<sup>270</sup> The AER does not approve augmentation capex for TNSPs in Victoria; this is determined instead by AEMO.

<sup>271</sup> 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.

<sup>272</sup> AER, Rule change request, Part B, 29 September 2011, p. 38.

<sup>273</sup> 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 period.

<sup>274</sup> Id., p. 40.

<sup>275</sup> AER, Rule change request, Part B, 29 September 2011, pp. 53-56; AER response to AEMC queries on AER network regulation rule change proposals, 1 February 2012, pp. 7-10.

difference between its allowed cost of capital and its true cost of capital. This might provide a basis to support an overspend, but capex incentives should not be designed to address cost of capital matters. However, 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 period, which has implications for the timing of capex and substitution between opex and capex; and
- capex above the allowance is not subject to any regulatory scrutiny, which means that there is a risk that any expenditure above this allowance may be inefficient.<sup>276</sup>

The Commission identified a number of options that might address these issues and sought stakeholders' views on these. It also decided to undertake further analysis, engaging consultants to assist.

The directions paper did not present a view on whether the AER should have discretion to use actual or forecast depreciation or whether a specific method should be prescribed in the NER. Nor did it come to a view on whether there was an issue with capitalised related party margins. Instead, the Commission decided to undertake further analysis on these issues, engaging consultants to assist. However, the Commission acknowledged that there is an incentive for NSPs to change their capitalisation policies during a regulatory period in order to recover opex again as a capex.

The remainder of this chapter is structured as follows:

- section 9.2 summarises the submissions received in response to the Commission's directions paper;
- section 9.3 outlines further consideration of the problems raised in respect of capex incentives;
- section 9.4 sets out the Commission's overall approach to addressing the problems identified with capex incentives;
- the following sections provide detailed analysis on each of the tools that comprise capex incentives, the Commission's draft rule and the intended interpretation. These tools are:
  - capex sharing schemes (section 9.5);
  - reviews of efficiency of past capex (section 9.6); and
  - actual or forecast depreciation (section 9.7); and

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<sup>276</sup> AEMC, Directions Paper, pp. 34, 40, 43.

- section 9.8 discusses related party margins and within-period capitalisation policy changes, and the draft rule provisions that are directed at these problems.

## 9.2 Submissions

### 9.2.1 Capex incentive sharing schemes/ex-post reviews

The AER agrees with the problems identified by the Commission in the directions paper. In addition, it also maintains that in certain circumstances the NER fail to create incentives to incur only efficient capex. In respect of a solution, the AER prefers the discretion to develop a capex sharing scheme in a guideline rather than having a mechanism prescribed in the NER such as the 60/40 sharing mechanism. However, the AER considers that it is inappropriate to introduce incentives that generate greater rewards for deferring capex from one regulatory period to another. Should the problem of deferral be addressed, the AER is open to alternative capex incentives including a symmetrical scheme.<sup>277</sup>

NSPs maintain their support for a principles-based, symmetrical capex sharing scheme as the appropriate means for addressing issues with capex incentives. However, they consider that the AER should have discretion not to introduce a capex incentive mechanism if it proves impracticable to address concerns regarding deferral. NSPs are not in support of ex post prudency and efficiency reviews of capex. They consider that a well-designed ex post prudency and efficiency review does not provide any additional incentives compared to a well-designed ex ante regime. In addition, they note that ex post prudency and efficiency reviews create regulatory risk and distort ex ante incentives for efficient investment.<sup>278</sup>

Consumer groups have a range of views on these matters. The EUAA and UnitingCare Australia state that there is an incentive in the NER for NSPs to overspend and support the thrust of the AER's 60/40 proposal.<sup>279</sup> The MEU agrees with the AER on the incentive to overspend and supports ex post scrutiny.<sup>280</sup> The Consumer Action Law Centre supports a range of mechanisms given the different ownership and governance arrangements of NSPs.<sup>281</sup>

Governments and other regulators broadly support further consideration of ex post prudency and efficiency reviews.<sup>282</sup> The SA DMITRE supports a symmetrical efficiency benefit sharing scheme (EBSS) in combination with ex post prudency and

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<sup>277</sup> AER, Directions Paper submission, 2 May 2012, p. 20.

<sup>278</sup> ENA, Directions Paper submission, 16 April 2012, pp. 29-32.

<sup>279</sup> EUAA, Directions Paper submission, 16 April 2012, p. 25; UnitingCare Australia, Directions Paper submission, 9 May 2012, p. 48.

<sup>280</sup> MEU, Directions Paper submission, 17 April 2012, pp. 23-26.

<sup>281</sup> Consumer Action Law Centre, Directions Paper submission, 16 April 2012, p. 5.

<sup>282</sup> IPART, Directions Paper submission, 16 April 2012, pp. 7-8; Vic DPI, Directions Paper submission, 16 April 2012, p. 6.

efficiency reviews limited to projects above a certain threshold.<sup>283</sup> On the other hand, the Vic DPI is not convinced that an additional capex incentive scheme will be in the long term interests of consumers.<sup>284</sup>

### 9.2.2 Actual/forecast depreciation

Some stakeholders agree with the views presented in the directions paper regarding the incentive to incur efficient capex under an actual depreciation approach compared to a forecast approach.<sup>285</sup> However, submissions from NSPs note that the use of actual depreciation creates a disincentive to invest in short-lived assets because a higher proportion of any savings made against the forecast can be retained by the NSP.<sup>286</sup> Therefore, to address capex efficiency incentives, NSPs favour the application of an EBSS over the use of actual depreciation.<sup>287</sup>

In contrast, the AER does not believe that the differing incentives to invest in short versus long lived assets was material given that short-lived assets are a relatively small proportion of the RAB and the scope to substitute was limited. As a result, the AER states that potential distortions are not significant enough to warrant exclusion of actual depreciation from the framework. In addition, the AER states that further guidance should not be provided in the NER, but if principles were included they should be at a high level and direct the AER to consider the interactions with the overall capex incentive framework in the decision to use actual or forecast depreciation.<sup>288</sup> Both Vic DPI and IPART support the AER's proposal that it be given this discretion.<sup>289</sup>

### 9.2.3 Related party margins/capitalisation policy changes

In respect of related party margins, UE and MG characterises the AER's concerns as largely theoretical.<sup>290</sup> The AER maintains that applying a capex incentive regime does not address incentives to incur inefficient related party margins.<sup>291</sup> The Vic DPI agrees with the AER that there is an incentive for NSPs to incur inefficient related party

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283 SA DMITRE, Directions Paper submission, 5 May 2012, pp. 3-4.

284 Vic DPI, Directions Paper submission, 16 April 2012, pp. 5-6.

285 See for example: ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 28-29; IPART, Directions Paper submission, 16 April 2012, pp. 8-9.

286 See for example: Jemena, Directions Paper submission, 16 April 2012, pp. 22-23; ENA, Directions Paper submission, 16 April 2012, pp. 33-34.

287 See for example: ENA, Directions Paper submission, 16 April 2012, p. 34; Grid Australia, Directions Paper submission, 16 April 2012, p. 8; Jemena, Directions Paper submission, 16 April 2012, p. 23.

288 AER, Directions Paper submission, 2 May 2012, pp. 21-25.

289 Vic DPI, Directions Paper submission, 16 April 2012, p. 10; IPART, Directions Paper submission, 16 April 2012, pp. 8-9.

290 UE and MG, Directions Paper submission, 16 April 2012, p. 6.

291 AER, Directions Paper submission, 2 May 2012, p. 29.



margins and that the issue needs to be addressed.<sup>292</sup> Similarly, the MEU is concerned about the use of related parties that could provide incentives for raising costs.<sup>293</sup>

NSPs have mixed views on how the problem could be dealt with. UE and MG support incentive mechanisms that encourage NSPs to minimise capex.<sup>294</sup> Jemena considers that an ex post review of new or changed margins may be appropriate.<sup>295</sup> UE and MG consider that an approach which excludes related party margins from being included in the RAB may have the unintended consequence of precluding network service providers from negotiating more favourable performance related contracts which would ultimately deliver better outcomes for consumers.<sup>296</sup> The AER has proposed that margins be either included or excluded in the RAB roll forward consistent with how those margins were treated in the determination.<sup>297</sup>

In respect of capitalisation policy changes, the joint submission of ETSA, CitiPower and Powercor suggest that decisions as to the inclusion of overheads in the RAB roll forward should be based on whether they were allocated to capex consistently with the capitalisation policy of the NSP at the time of the determination.<sup>298</sup> Jemena considers that stronger capex incentives through a well-constructed EBSS will deal with the capitalisation issue by removing the incentive to capitalise operating expenditure.<sup>299</sup> Similarly, the ENA considers it appropriate that the AER should retain the ability to calculate operating and capital expenditure efficiency gains under an EBSS in a manner that removes the effect of changes to the classification of expenditure.<sup>300</sup>

### **9.3 Further consideration of the problems raised in respect of capex incentives**

#### **9.3.1 Report on capex overspends**

The Commission undertook further work on the circumstances in which a NSP would need to spend more than its capex allowance. This was to further understand the issues the Commission identified regarding capex incentives, and to form a basis on which to develop solutions. It also sought submissions on this issue and engaged Parsons Brinckerhoff to assist with this.

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292 Vic DPI, Directions Paper submission, 16 April 2012, pp. 10-13.

293 MEU, Directions Paper submission, 17 April 2012, p. 61.

294 UE and MG, Directions Paper submission, 16 April 2012, p. 7.

295 Jemena, Directions Paper submission, 16 April 2012, p. 25.

296 UE and MG, Directions Paper submission, 16 April 2012, pp. 6-7.

297 AER, Directions Paper submission, 2 May 2012, p. 29.

298 ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 33.

299 Jemena, Directions Paper submission, 16 April 2012, p. 25.

300 ENA, Directions Paper submission, 16 April 2012, p. 35.

Parsons Brinckerhoff identified a range of theoretical drivers as to why a NSP might spend more than its capex allowance. These include:

- corporate governance including asset management capability and forecasting, estimating and planning ability of the NSP;
- unpredictable events/uncontrollable costs such as natural disasters, eg Victorian bush fires, macro-economic factors such as Gross Domestic Product (GDP) growth and inflation;
- delivery risks such as changes in input prices, eg for labour and equipment, and unforeseen conditions at construction sites; and
- the regulatory framework such as the capex incentives in the NER and whether a service target performance incentive scheme is in place.<sup>301</sup>

However, from a practical point of view, case studies of NSPs suggest that many of the drivers of capex overspends are in fact able to be mitigated or at least controlled. Harder to control though are capex overspends to meet unexpected growth in demand for new connections because these are primarily a function of macro-economic conditions. Also compliance with unanticipated regulatory obligations or requirements for the provision of regulated services is hard to control.<sup>302</sup>

Parsons Brinckerhoff considers that the ability to defer expenditure is one of the ways in which some of these uncontrollable factors might be mitigated. A NSP is likely to look more closely at options for deferring capex the closer it gets to exceeding its allowance. For example, ElectraNet commented that if planned capex was likely to exceed the allowance, then it would typically reassess its planned projects and look at available deferral or scope for change options that help reduce capex. Parsons Brinckerhoff also noted that:

“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.<sup>303</sup>”

While there may currently be stronger incentives to minimise opex than capex, nothing in the work that Parsons Brinckerhoff has undertaken indicates that the current

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<sup>301</sup> Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 16 August 2012, chapter 2.

<sup>302</sup> *Id.*, pp. 32-33.

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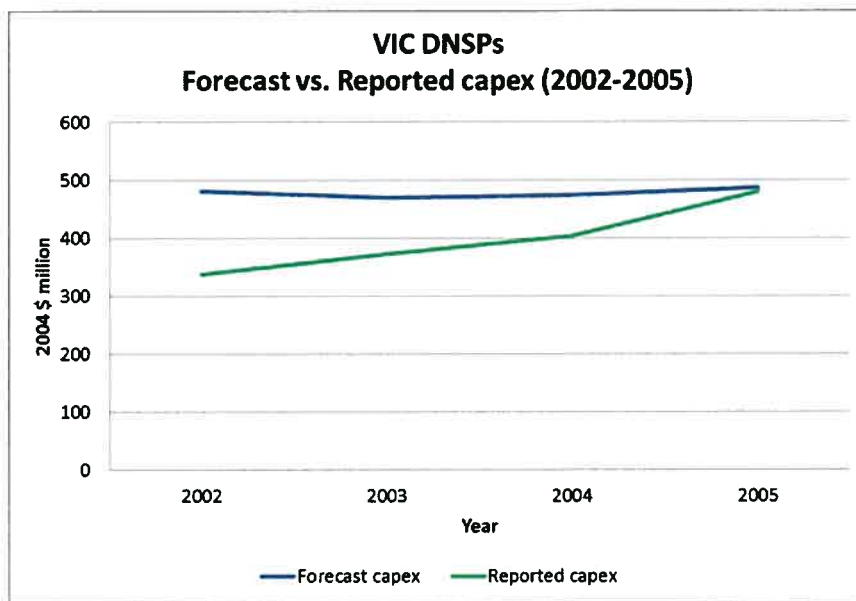
<sup>122</sup> Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

regulatory framework provides NSPs with an incentive to overspend their allowances. However, Parsons Brinckerhoff has also noted that insufficient regulatory oversight would strengthen the potential for capex overspends through a lack of consequences.<sup>304</sup>

### 9.3.2 Further analysis of problems

Further work undertaken provides additional support for the problems with the current capex incentives framework as identified in the directions paper. In respect of the incentive to defer capex, the Victorian DNSP Annual Performance Report from 2010, as published by the AER, indicates that amongst Victorian DNSPs there is a tendency to defer capex towards the end of regulatory periods. Figure 9.1 and Figure 9.2 below track capex allowances and reported capex during two regulatory periods: the first in which there was an EBSS; and the second where there was no EBSS.

**Figure 9.1 Victorian DNSPs allowance versus reported capex for the period 2002-2005**

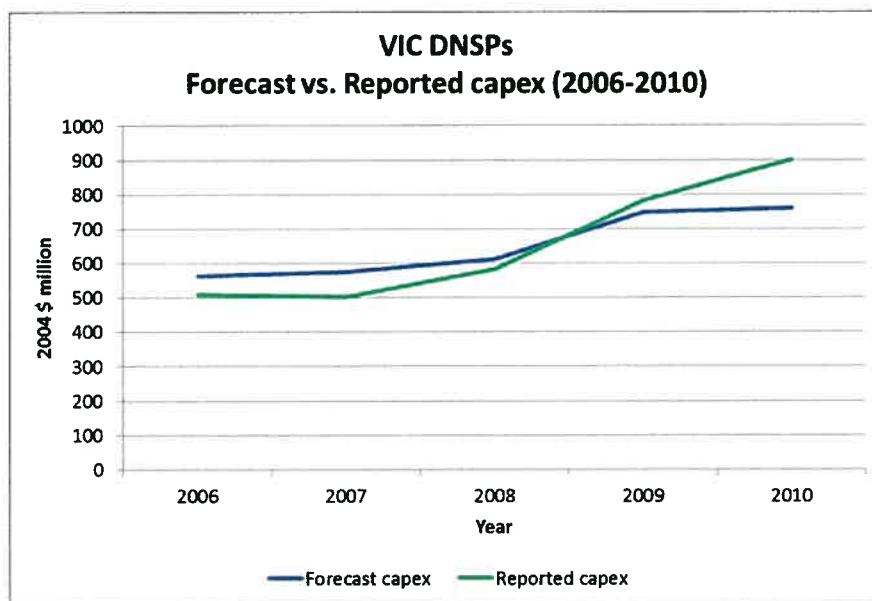


Source: AER, Victorian Electricity Distribution Network Service Providers Annual Performance Report 2010, May 2012, p. 94.

303 Id., p. 33.

304 Ibid.

**Figure 9.2** Victorian DNSPs allowance versus reported capex for the regulatory period 2006-2010



Source: AER, Victorian Electricity Distribution Network Service Providers Annual Performance Report 2010, May 2012, p. 94.

Some of the data presented in the Parsons Brinckerhoff report suggests a similar tendency. For example, in Ausgrid's last regulatory period, its actual capex increased significantly compared to the allowance.

**Figure 9.3 Example of capex in previous regulatory period**

Capital expenditure in previous regulatory period (\$m) \$ values expressed in (\$m, nominal)						
Capital Expenditure Category	2004/05		2005/06		2006/07	
	Allowance	Actual	Allowance	Actual	Allowance	Actual
Asset renewal/replacement		151.3		214.3		270.1
Augmentation to meet peak demand growth		203.5		248.2		369.5
Quality, reliability and security of supply enhancement		7.5		9.9		10.2
Environmental, safety and statutory obligations (excluding reliability)		47.0		40.9		34.2
Non-network assets		48.8		64.4		72.0
Other		0.0		0.0		0.0
<b>Total</b>	<b>452.9</b>	<b>458.1</b>	<b>497.5</b>	<b>577.7</b>	<b>681.2</b>	<b>755.9</b>

Capital expenditure in previous regulatory period (\$m) \$ values expressed in (\$m, nominal)						
Capital Expenditure Category	2007/08		2008/09		Total	
	Allowance	Actual	Allowance	Actual	Allowance	Actual
Asset renewal/replacement		273.1		312.6		1,221.4
Augmentation to meet peak demand growth		480.6		642.8		1,944.5
Quality, reliability and security of supply enhancement		13.6		25.3		66.5
Environmental, safety and statutory obligations (excluding reliability)		29.1		34.8		185.9
Non-network assets		113.8		209.8		508.9
Other		0.0		9.6		9.6
<b>Total</b>	<b>689.7</b>	<b>910.3</b>	<b>690.9</b>	<b>1,234.9</b>	<b>3,012.2</b>	<b>3,936.9</b>

Source: Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 16 August 2012, p. 12.

## 9.4 Overall approach

### 9.4.1 Providing the AER with discretion

This section sets out, broadly, how the Commission proposes to address the identified problems.

The AER should have access to a range of "tools" that can be used to create incentives for NSPs to undertake efficient capex. These tools are reviews of capex efficiency, capex sharing mechanisms and the use of actual or forecast depreciation and are described in further detail below. The AER is generally best placed to determine which 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 will allow the AER to apply and tailor the incentives. Scope for the AER to use a range of tools and adapt those tools over time recognises that the best incentives for efficient capex may not be the same for all NSPs or the same over time. The experience of other regulators such as Ofgem, who have gradually developed their approach to incentives for capex, illustrates that learning from how incentives work and adapting them can help to improve overall outcomes for customers. Importantly, the use of incentives by the AER to encourage dynamic efficiency – which would include innovation – should deliver benefits to consumers in the longer term, as required by the NEO. This longer term focus is critical.

The Commission's view is that, 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.

#### **9.4.2 Objective, guidelines and principles**

The draft rule provides for an overall objective for capex incentives that is consistent with the NEO and RPP. This objective describes what the capex incentive regime, as a whole, should aim to achieve. It provides that only capex that is included in an adjustment that increases the value of the RAB is capex that reasonably reflects the capex criteria. This will be particularly relevant when the AER is considering what its overall approach should be to capex incentives. Should it use one tool and none of the others or should it use all of the available tools? As well as guiding the AER on its overall approach to capex incentives, the objective will guide the AER in the development and application of the tools themselves to individual NSPs. It will also be relevant for the appeal body to consider this objective when assessing any merits reviews on elements of the capex incentives regime. Importantly, the objective does not act as a mandatory requirement or a prohibition, but a source of direction for the capex incentives regime.

The capex incentive objective has been 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 should include trading off investment in new and replacement assets, maintenance of existing assets and other options such as demand side management.<sup>305</sup> It also includes the efficient timing of capex and whether expenditure incurred reflects that which would have been incurred by a prudent NSP. The capex incentive objective is framed in terms of ensuring the capex that is included in the RAB reasonably reflects the capex criteria.

To provide greater certainty around how capex incentives are to be utilised, the AER is required under the draft rule to set out its approach to capex incentives in guidelines.

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<sup>305</sup> In practice, efficiency can only be measured by comparison to other companies.

This is where the AER must set out the approach to capex sharing schemes and the manner in which it proposes to undertake efficiency reviews of past capex and determine whether to use actual or forecast depreciation. In putting together its guidelines, the AER will need to take a coordinated approach to capex incentives. The AER has the flexibility to develop different tools for different NSPs. The guidelines would set out these different approaches, but the specific regulatory determination for each NSP would develop the specifics to apply. Whatever combination of tools it develops, the guidelines must include an explanation of how that combination achieves the capex incentive objective. The first guidelines will be required to be put in place by 30 August 2013.

Finally, an additional measure of certainty is provided in respect of each of the tools. Included in the draft rule are principles that the AER must consider when it first develops and then applies one of the tools. The Commission intends only that the regulator has considered these principles and explained how it has considered the issues. The Commission does not intend that the regulator's approach to capex incentives must be done in a way that necessarily achieves the principles.

The Commission expects that this combination of an overall objective with a requirement for guidelines and then specific principles will provide for capex incentives to be applied in a transparent and accountable manner.

#### **9.4.3 Capex incentive tools**

The capex incentive tools to which the AER will have access are:

- capex sharing schemes;
- efficiency reviews of past capex; and
- whether to depreciate the RAB using actual or forecast capital expenditure to establish a NSP's opening asset base.

These options will be discussed in sections 9.5, 9.6 and 9.7.

The ex ante capex allowance, which is described in chapter 8 also provides capex incentives. For example, an allowance that represents the efficient costs of a NSP will provide incentives for NSPs to incur efficient capex as they have to bear some of the cost of any expenditure above this allowance for the remainder of the regulatory period.

The Commission considered a number of other options that it is not proposing to specify in the NER. These include the AER's 60/40 proposal, not allowing any expenditure above the allowance to be rolled into the RAB, menu regulation and ex post optimisation of the RAB. These are also considered further below.

## 9.5 Capex sharing schemes

### 9.5.1 Analysis

#### Background to 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.

Importantly, capex sharing schemes can be implemented in a range of ways. Energy regulators in Australia and in Great Britain have provided some examples of what these schemes may look like, and have typically adopted one of three forms: a fixed carry-over period before true-up, a periodic true-up to achieve an incentive rate specified ex-ante or annual true-ups to achieve the ex-ante incentive rate. Examples of these types of schemes are included in Appendix A.

Energy regulators in Australia have tended to use a form of capex sharing scheme that allows the NSP to retain the financial benefits from making efficiency improvements for a fixed period regardless of when the improvements occur in the regulatory period. For example, a saving incurred in year three of one regulatory period would be retained by the NSP until year three of the next regulatory period. The Essential Services Commission of Victoria (ESCV) applied such a capex sharing scheme in the 2001-2005 regulatory period in respect of electricity distribution.<sup>306</sup> Essential Services Commission of South Australia (ESCOSA) has also applied a similar scheme in the past.<sup>307</sup>

The incentive rate is the proportion of benefits retained by the NSP and in these schemes is determined by the length of the carry-over period and the magnitude of the rate of return. A longer (shorter) carry-over period will result in a higher (lower) incentive rate while a higher (lower) rate of return will result in a higher (lower) incentive rate.

In contrast, Ofgem in Great Britain has previously explicitly fixed an incentive rate ex ante and made an adjustment at the start of the following regulatory period such that the NSP receives the specified share of any efficiency gains or losses.<sup>308</sup> The ex-ante incentive rate is usually set as part of a menu of choices contained in Ofgem's Information Quality Incentive mechanism. Ofgem's approach has developed and will in future involve an annual true up of efficiency gains and losses to achieve the ex-ante

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<sup>306</sup> ESCV, Electricity Distribution Price Review 2006, Final Decision, October 2006, pp. 419-430.

<sup>307</sup> ESCOSA, 2005-2010 Electricity distribution price determination, Part A - Statement of Reasons, April 2005, pp. 67-73.

<sup>308</sup> Ofgem, Electricity Distribution Price Control Review, Final proposals, November 2004, p. 98.



incentive rate with a two year lag, which allows for the use of fully audited accounts.<sup>309</sup>

Chapter 6 of the NER currently provides for a form of capex sharing scheme under the efficiency benefit sharing scheme provisions, though this is discretionary.<sup>310</sup> There is no equivalent provision in Chapter 6A. The AER has determined not to develop an efficiency benefit sharing scheme under these provisions due to concerns that it would encourage inefficient deferral of capex into future regulatory periods.<sup>311</sup> The ESCV removed its capex sharing scheme for Victorian DNSPs for the 2006-2010 regulatory period due to similar concerns.<sup>312</sup>

### **Background to menu regulation**

Menu regulation is aimed at addressing similar incentive problems as efficiency sharing schemes, yet has broader aims. It has been adopted by Ofgem and Ofwat in Great Britain.<sup>313</sup> It consists of a set of forecasts from the NSP and the regulator. The regulator uses these to set a menu of expenditure allowances and incentive rates from which the NSP must choose. The incentive rates are set on a sliding scale such that the lower the allowance chosen by the NSP relative to the regulator's forecast, the higher the incentive rate. The incentive rate is then applied to the gap between the actual outcome and the allowance. Additional income is provided to NSPs based on how close their actual expenditure is to their original forecast. Menu regulation is therefore not only designed to encourage efficient capex but also encourage more accurate forecasting. Ofgem also closely monitors service levels as part of its scheme known as the Information Quality Incentive scheme.

The Commission notes that menu regulation in the form such as that adopted by Ofgem would require a different approach to the provision of forecasts and incentives than the current model in the NER. It has therefore decided not to specifically allow for this option in the NER at this stage. However, the Commission notes that the AER could explore the adoption of menu regulation in some form using the new power to develop small scale pilot schemes subject to the limits under that power, as discussed in chapter 11, at section 11.4.

### **How capex sharing schemes address the identified problems**

In general, 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. In this way, the AER should be able to use these schemes to encourage appropriate network investment. It will also encourage NSPs to look for efficiencies, such as by innovation. This is in contrast to reviews of efficiency of past capex, for example, which

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<sup>309</sup> Ofgem, TPCR4 Rollover: Final proposals, Final decision, November 2011, p. 68.

<sup>310</sup> NER clause 6.5.8(b).

<sup>311</sup> AER, Directions Paper submission, 2 May 2012, p. 20.

<sup>312</sup> ESCV, Electricity Distribution Price Review 2006, Final Decision, October 2006, pp. 10, 431-433.

<sup>313</sup> For a more detailed description of the approach see, for example: IPART, *Incentives for cost saving in CPI-X regimes*, IPART Working Paper, July 2011.

would primarily only discourage inefficient overspends (see section 9.6 below). Finally, it should also provide an incentive for NSPs to reveal their efficient costs.

A capex sharing scheme could also, depending on how it is applied by the AER, contribute to addressing the problems the Commission has identified with the existing capex incentives. A scheme could, for example, be designed to provide for a continuous incentive, that is, the incentives would be set so that the incentive power is the same no matter which year of a regulatory period an investment is made. Since the incentive power at the end of a regulatory period would no longer be less than that at the start of the period, the problem of inefficient deferral of capex within a regulatory period should be addressed. Further, any stronger incentives, including towards the end of the regulatory period, should make it likely that there would be less capex above the allowance and therefore less need for scrutiny of actual capex undertaken. A capex sharing scheme is likely to provide the AER with greater confidence that the capex going into the RAB is efficient.

One problem with capex sharing schemes is that it may be difficult to identify whether reductions in capital expenditure 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. In addition, NSPs are subject to service target performance incentive schemes and regulatory obligations which may affect their ability to respond to capex incentives in that way. The ESCV in respect of gas and Ofgem in Great Britain have both developed ways which attempt to address this problem. A lower powered incentive could also be adopted as a means of reducing the potential size of the problem. While there may be difficulties in applying these schemes, the benefits should outweigh these difficulties. There is room for further innovation in this area.

### **Capex sharing scheme principles**

The draft rule gives the AER the power to implement capex sharing schemes of its own design subject to certain principles.

The first principle concerns rewards and penalties. The scheme should reward the NSP for undertaking efficient capex and penalise the NSP for undertaking inefficient capex. In coming to this principle, the Commission considered whether the scheme should allow for a penalty only regime such as the AER's 60/40 proposal. The purpose of this approach proposed by the AER was to provide an incentive for NSPs not to overspend. In the directions paper, the Commission raised concerns regarding the prescriptive nature of this approach, and also with the lack of a continuous incentive. The Commission was also concerned that the approach would provide penalties for assumed inefficient expenditures but not rewards for efficient expenditure. The 60/40 proposal would therefore not be consistent with the first principle.

The second principle concerns the size of the rewards and penalties. While there is a measure of symmetry in a scheme that provides for both rewards and penalties, a scheme should not have to be "mathematically symmetrical". 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. Such an approach would be overly prescriptive and could prevent some schemes that would be beneficial. In a general sense, the level of reward or penalty should be commensurate with the level of efficiency or inefficiency of capex. That is, the financial reward to the NSP should bear some relationship to the efficiency benefit and the financial penalty on the NSP should bear some relationship to the inefficiency penalty, but the size of a reward or penalty for some magnitude of efficient or inefficient capex need not be the same. This is consistent with similar principles in the NER in respect of existing incentive schemes.

The third principle is that penalties should not be imposed on NSPs that undertake capex in an efficient manner. To put it another way, 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.

The NER create other incentives for NSPs, and NSPs are required to comply with various legally binding requirements in providing their regulated services. Accordingly the draft rule requires the AER to take into account both of these matters when designing a capex sharing scheme. The principles and matters referred to above, as well as the NSP's circumstances, must also be taken into account by the AER in determining whether, and how, to apply the capex sharing scheme to a particular NSP.

The Commission does not support a principle which provides that a capex sharing scheme should be continuous. A principle of this nature could discourage some schemes which are appropriate. At the same time, the Commission takes the view that in most cases a continuous incentive is preferable to a declining incentive. A constant incentive power is relevant in capex in order to provide an equal incentive to invest in each year of a regulatory period. Anything other than an equal incentive may provide incentives for NSPs to defer expenditure, even where it is not efficient to do so. The Commission agrees with the EUAA and UnitingCare Australia that a declining incentive in capex and a constant incentive in opex may encourage inefficient substitution between opex and capex.<sup>314</sup> Some issues relating to inefficient substitution between opex and capex, particularly in respect of demand side management, are being examined as part of the Commission's Power of Choice Review.

The draft rule permits the AER to apply schemes differently to NSPs or even to apply different schemes. So, for example, the AER could apply stronger incentives where a NSP traditionally spends more than its allowance and weaker incentives where the AER is concerned about inefficient deferral into future regulatory periods.

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<sup>314</sup> EUAA, Directions Paper submission, 16 April 2012, p. 24; UnitingCare Australia, Directions Paper submission, 9 May 2012, p. 47.

## Differences from the current EBSS

As described above, the AER has not used its power in Chapter 6 of the NER to apply an EBSS in respect of capex on the basis that it may lead to inefficient deferral of capex. It is possible that the AER could take the same view in relation to the draft rule provisions for capex sharing schemes. However, there are some important differences between the EBSS and what is proposed here. For a start, an overall capex incentive objective is proposed to be added to the NER, and the AER will need to consider and justify its overall approach to capex incentives in terms of that objective. It is likely that all approaches will have some advantages and disadvantages, but the AER will need to consider whether at an overall level the approach is the best one to meet the overall objective, and the NEO and RPP.

In addition, under the principles described above, the AER will have more flexibility than it currently does under the Chapter 6 EBSS principles. For example, nothing in the principles described above obliges the AER to implement a scheme which has continuous incentives. This may allow the AER to design a scheme which does not create incentives to inefficiently defer capex from one regulatory period to the next.

In respect of the risk of inefficient deferral, the ENA has commented that:

“Perhaps the most challenging [implementation issue] is the need for measures to avoid creating incentives for NSPs to inefficiently defer capital expenditure from one regulatory period to the next. Similar continuous incentive schemes apply in other jurisdictions, and in these jurisdictions mechanisms exist to address the deferral incentive.<sup>315</sup>”

In the draft rule, the current EBSS has been retained in respect of opex and distribution losses but has been removed for capex.

### 9.5.2 Guidance on draft rule

#### Process

The process of developing and applying a capex sharing scheme is 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

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<sup>315</sup> ENA, Directions Paper submission, 16 April 2012, p. 29.

- 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**

While the principles provide for rewards and penalties, the principles do not require that there be mathematical symmetry between those rewards and penalties. That is, NSPs are rewarded with a set portion of any efficiency gains and are penalised by a set portion of any efficiency losses. This could be implemented by the AER by reference to a benchmark. 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 70 per cent and only \$300,000 is recovered in revenues. However, the AER is required to explain in its guidelines how this scheme is consistent with the capex incentive objective.

It should be noted that the use of the terms 'efficiency' and 'inefficiency' are not intended to define any amount above or below the allowance. Specifically, it will be for the AER to define efficient and inefficient expenditure, as well as the relevant benchmark. The purpose of not defining such terms in the draft rule is to give the AER the flexibility to interpret and apply as it sees most appropriate.

The draft rule requires the AER to take into account the interaction of the scheme with other incentives and obligations, 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 may consider adopting a higher powered scheme where it has access to extensive information on service standards. The AER must also take into account regulatory obligations and requirements on NSPs such as reliability and service standards and the relevant circumstances of the NSP.

The principles can accommodate different types of schemes. Examples of schemes that would be permitted by the draft 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 draft rule could be implemented.

## **9.6 Reviews of efficiency of past capex**

### **9.6.1 Analysis**

#### **General approach to reviews of efficiency of past capex**

In the directions paper, the Commission observed that reviews of efficiency of past capex would address the lack of supervision problem that it identified. The Commission remains of the view that such reviews are the most direct way of

addressing this problem since they give the regulator the chance to check that the capex to be recovered is efficient.

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. IPART uses them in the rail and water sectors and has excluded expenditure as a result of a review. For example, it excluded \$61 million expenditure in 2003 incurred by Sydney Water Corporation relating to a discontinued customer billing system project.<sup>316</sup> It excluded \$0.84 million in the same year from Hunter Water Corporation for purchase of some land for a dam site for a project that it did not consider was required.<sup>317</sup> IPART, in its submissions, is supportive of these reviews.<sup>318</sup> The ESCV also uses them to regulate the water sector.<sup>319</sup>

The ERA in WA also regularly reviews the efficiency of past capex of service providers. For example, it has applied such reviews in respect of Western Power, a NSP. A feature of the regime is that it allows Western Power to obtain pre-approval of expenditure above the allowance to provide the NSP with greater certainty that the regulator will allow the expenditure *ex post*.<sup>320</sup> The ERA recently excluded \$261 million of capital expenditure incurred in one period from the opening capital base for the next period.<sup>321</sup>

These mechanisms are also available to energy regulators in Great Britain and in the United States of America. Professor Yarrow has noted the greater significance of *ex post* supervision in the United States of America compared to Great Britain.<sup>322</sup>

Analysis of reviews of efficiency of past capex by other regulators indicates that in many cases these reviews are conducted on a project by project, or "bottom up" basis. That is, the regulator considers a particular project that was undertaken and assesses whether that project was undertaken efficiently. The Commission considers that while

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<sup>316</sup> IPART, Sydney Water Corporation – Prices of water supply, wastewater and stormwater Services – From 1 July 2003 to 30 June 2005, Determination 4, May 2003, p. 19.

<sup>317</sup> IPART, Hunter Water Corporation, Prices of water supply, wastewater and stormwater services, From 1 July 2003 to 30 June 2005, Determination 3, May 2003, p. 19.

<sup>318</sup> IPART, Directions Paper submission, 16 April 2012, p. 7; IPART, Consultation Paper submission, 8 December 2011, pp. 11-12.

<sup>319</sup> See for example: ESCV, 2008 Water price review, Regional and rural businesses' water plans 2008-2013, Melbourne Water's drainage and waterways water plan 2008-2013, June 2008, pp. 21, 26, 58, 64, 84; PwC, Essential Services Commission urban and rural water price review 2008: assessment of demand forecasts, Barwon Water, Final report, Report for ESCV, March 2008, pp. 16-17; Sinclair Knight Merz (SKM), Expenditure forecast review for the Victorian regional urban water businesses, Barwon Water, Final report, Report for ESCV, March 2008, pp. 3-4.

<sup>320</sup> Economic Regulation Authority of Western Australia (ERAWA), Proposed revisions to the access arrangement for the South West Interconnected Network submitted by Western Power, Final decision, December 2009, pp. 291-292.

<sup>321</sup> ERAWA, Proposed revisions to the access arrangement for the South West Interconnected Network submitted by Western Power, Final decision, December 2009, pp. 200-201.

<sup>322</sup> See for example: George Yarrow, Preliminary Views for the AEMC, 12 February 2012, pp. 14-15.

this approach may be appropriate in some cases, any review of past capex by the AER should not be limited to a bottom up consideration. The reviews should consider the totality of the capex undertaken and use a range of techniques to assess whether this capex was, as a whole, efficient. For example, the AER may use benchmarking techniques to compare capex undertaken by one NSP with the capex required by other NSPs. Such reviews might also focus on the processes that NSPs have in place to decide which capex projects to undertake. A regulator may be able to obtain some assurance that a NSP's actual capex is likely to be efficient based on confidence that it has robust processes to determine the need for capex and manage projects within efficiency levels of cost.

The Commission supports the AER using a range of analytical techniques when assessing capex forecasts, as discussed in chapter 8 above. This approach allows the AER to treat capex as a whole, rather than on a project by project basis, when assessing the ex ante capex allowances for a NSP.<sup>323</sup> A similar approach could be taken in respect of reviews of past capex.

Ex post optimisation of the RAB was also raised in the directions paper as a way to address the lack of supervision problem. It is a form of review of past capex. This option is being considered as part of a rule change request from the MEU.<sup>324</sup> As set out in the draft determination on that rule change request, the Commission does not support this option. Among other things, it would require the AER to assess capex from the detail of specific projects and assets. In addition, the Commission considers that the ex post optimisation of the RAB could provide disincentives for future efficient investment due to increased risks to NSPs. It also considers optimisation would increase the complexity and costs of the regulatory process.<sup>325</sup>

In effect, the draft rule requires the AER to undertake a review of the efficiency of past capex for all NSPs as part of the regulatory determination process. This is because the draft rule requires the AER to make a statement on the efficiency of expenditure going into the RAB in its draft and final determination for each NSP. The Commission is concerned about expenditure going into the rolled forward RAB as this is the value used to determine the return on capital and depreciation building block components that will determine the revenue that a NSP can earn on the expenditure incurred. However, the draft rule only allows the AER to preclude expenditure from being rolled into the RAB as a result of a review if a NSP has spent more than its allowance for a specified period. The exception to this provision is expenditure relating to related party margins and as a result of within-period changes to the NSP's capitalisation policy, which is discussed in section 9.8. It is the AER's decision as to whether it considers it appropriate in the specific circumstances to exercise this power. In addition, the draft rule restricts the amount of expenditure that can be excluded from the RAB to the amount of any expenditure above the allowance. The Commission considers that

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<sup>323</sup> See for example the use of the word "total" in clause 6.5.7(c).

<sup>324</sup> MEU, Optimisation of Asset Base and Use of Fully Depreciated Assets Rule change request, October 2011.

<sup>325</sup> AEMC, Optimisation of Regulatory Asset Base and the Continued Use of Fully Depreciated Assets, Draft Rule Determination, 21 June 2012.

setting the best possible ex ante allowance for capex is important, and also that the use of ex ante incentive mechanisms for capex have 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 being included in the RAB if they have overspent the ex ante allowance and the AER's incentive guidelines will be required to set out the manner in which the AER proposes to approach it.

### **Benefits of a review of the efficiency of past capex**

Reviews of the efficiency of past capex would, as described above, provide scrutiny of capex that has been undertaken. This risk of an inability to recover for inefficient expenditure would therefore provide an incentive for NSPs to avoid inefficient capex as this may result in allowances being exceeded. Ex ante incentives, while effective, do not ensure that NSPs never undertake inefficient capex. A further check that what is rolled into the RAB is efficient is therefore in the long term interests of consumers.

The Commission considers there to be additional benefits in undertaking reviews of the efficiency of past capex as a complement to ex ante reviews of capex. 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. Further, 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 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.<sup>326</sup>”

The review of efficiency of past capex should also assist the AER in determining an appropriate ex ante allowance by better understanding 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 overspends.

NSPs and the AER have raised a number of concerns in submissions about reviews of efficiency of past capex.<sup>327</sup> The AEMC also determined not to allow for reviews of the efficiency of past capex in 2006.<sup>328</sup> These concerns include that the reviews may add to regulatory risk, and that a NSP may not undertake efficient and required investment and implementation challenges. 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

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<sup>326</sup> 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.

<sup>327</sup> AER, Rule change request, Part B, 29 September 2011, pp. 43-44.

<sup>328</sup> AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, pp. 98-99.



efficiency. Indeed such a review should act to give the regulator greater confidence about the efficiency of the NSP's future capex projections.

To mitigate any potential for an increase in regulatory risk, the draft rule is that the amount of capex that may be precluded from being rolled into the RAB will be limited to the extent of any over expenditure of the capex allowance for the relevant period. If the NSP does not overspend, no reduction will be possible. This is discussed further below. Finally, the requirement for the AER to set out its approach to these reviews in a guideline which must be consulted on should create more certainty for the NSP.

Stakeholders have also commented that there may be implementation challenges with reviews of the efficiency of past capex.<sup>329</sup> It is likely that such reviews will require additional work by the AER. However, given that such reviews are expected to be conducted at the same time as the AER considers the ex ante capex allowance for the next regulatory period, there should be synergies that the AER can take advantage of, such as in respect of the information that the AER would need. As for the evidentiary burden, it is unclear why that should be any different from the evidentiary burden that the AER has when it considers ex ante allowances, which are discussed in more detail in chapter 8. The AER should be able to use a variety of approaches to determine the efficiency of capex including top down and bottom-up analysis. The specific approach adopted by the AER could also be tailored to the amount of any overspend. For example, the AER might undertake a more intrusive approach where a NSP has spent significantly more than its allowance and a less intrusive review where the amount of expenditure above the allowance was smaller, and a strong ex ante incentive had been in place.

Finally, examples are provided above of reductions made by other regulators following such reviews. It appears that these regulators have been able to overcome any implementation and evidentiary challenges. Indeed, IPART indicates that it very much supports regulators having the power to undertake reviews of the efficiency of past capex.<sup>330</sup>

In line with the general approach to reviews of the efficiency of past capex set out in the previous section, the Commission has determined to make a draft rule which has the following two elements:

- Reducing the amount of capex to be rolled into the RAB - the AER may preclude expenditure above a NSP's allowance from being rolled into the RAB<sup>331</sup>; and
- Statement on the efficiency of past capex – as part of a regulatory determination for a NSP, the AER must make a statement on the efficiency of capex being rolled into the RAB.

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<sup>329</sup> See for example: ENA, Directions Paper submission, 16 April 2012, pp. 31-32.

<sup>330</sup> IPART, Directions Paper submission, 16 April 2012, p. 7.

<sup>331</sup> 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.

### **Reduction for inefficient expenditure**

This sub-section deals with the AER's power to make a reduction to the amount of capex to be rolled into the RAB. This is discretionary, and is separate to the obligation included in the draft rule for the AER to include in each regulatory determination a statement as to the overall efficiency of the capex rolled into the RAB as part of that regulatory determination. This obligation is discussed in the next sub-section.

The power to reduce the amount of capex to be rolled into the RAB is one of the tools the AER has at its disposal as part of the overall capex incentives regime. As such, the AER must coordinate its approach to this power with the other tools it has. It must do this by setting out in the capex incentive guidelines how it intends to approach imposing such a reduction.

The focus in the draft rule on the overall amount to be rolled into the RAB is intended to encourage the AER to undertake a review of the total capex incurred by the NSP during the specified period rather than just looking at individual projects. In undertaking the 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 is 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 AER may only preclude expenditure from being rolled into a NSP's RAB if the NSP has spent more than its allowance for a specified period. In addition, the draft rule only allows the AER to reduce the amount rolled into the RAB by the amount of any expenditure above the allowance. As identified in the directions paper, the Commission considers 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.

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 indicates, while there are often unexpected additional costs for a NSP during a regulatory period, there will also be unexpected reductions in costs.<sup>332</sup> In addition, the NSP should be able to take mitigating actions, such as re-prioritising capex, to avoid spending over its allowance, or seek a cost pass through if the relevant test is met. Indeed, on this basis, there is an argument that no capex above the level of the ex ante allowance should be

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<sup>332</sup> Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 16 August 2012, p. 33.

rolled into the RAB. However, to accommodate unforeseen circumstances where a NSP has legitimately spent more than its allowance, the AER should have the ability to make an assessment of the amount of the overspend that may be rolled into the RAB.

The Commission considered whether a pre-approval process such as that adopted by the ERA in Western Australia could be applied. While the Commission notes that this mechanism can provide for greater certainty for NSPs it does not support adopting a pre-approval mechanism in the NER. This would not be consistent with the general approach which is to encourage the AER to undertake a review of the total capex rather than individual projects. This process could also be administratively burdensome for the AER given the number of NSPs that it regulates.

The operation of the draft rule is explained further in the guidance section below. However, it is relevant to discuss three further elements here.

First, it is significant that the test in the draft rule that the AER must apply in determining whether to preclude expenditure from being rolled into the RAB 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 had or could reasonably be expected to have had access to at the time it undertook the capex.

Finally, whilst an AER decision to preclude capex that would otherwise be rolled 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. 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 considers 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 focused only on the outcomes of the review of 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 rolled into the RAB**

In addition to the discretion to make a reduction in the amount of capex rolled into the RAB, the Commission considers it is appropriate that the AER should consider the overall efficiency of capex that is rolled into the RAB. While the reduction described in the previous sub-section only applies where there is an overspend, the requirement to consider the overall efficiency of capex will require the AER to go further and consider the efficiency of capex even where the ex ante allowance has not been exceeded. The

fact that capex in excess of the ex ante allowance can be efficient was discussed above; recognised here is the principle that capex below the allowance can still be inefficient.

This obligation is part of the overall approach towards a greater focus on the efficiency of NSPs in the NER. The annual benchmarking reports, discussed in chapter 6, should mean that the AER develops an overall understanding of the relative efficiency of NSPs on an annual basis. When the AER then comes to considering, for a particular NSP, whether the capex to be rolled into the RAB at a reset is efficient the AER should already have some understanding of the relative efficiency based on its annual analysis. A deeper understanding of whether what is rolled into the RAB is efficient should in turn provide an insight into how the NER are operating to encourage NSPs to achieve efficiency. This would include whether the AER is setting the ex ante allowances at the right level, and whether the capex incentives are operating to deliver efficient outcomes. In addition, conducting this assessment of the overall efficiency of a NSP's capex should assist the AER to better understand whether to make a reduction in respect of any overspends.

In line with the overall approach of giving the AER greater discretion and allowing flexibility, few requirements have been included in the draft rule around how the AER must undertake this task. Some guidance is set out below. 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 period.

### **9.6.2 Guidance on draft rule**

#### **Reduction for inefficient expenditure**

The draft 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 an exclusion of incurred capex.

The years that comprise this period will not match any one regulatory 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 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 time frame set out in the draft rule, three years of data from the current regulatory period will be available at the time of the regulatory proposal assuming a five year regulatory period. The draft rule intends that the period in respect of which the overspend will be assessed should comprise:

- the years in the current regulatory 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 period where the regulatory period is five years; and
- the last two years of the previous regulatory period which will not previously have been the subject of an ex post review 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 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 period will not be considered until the following regulatory determination.

As identified above, the AER will set out the manner in which it will determine to preclude incurred capex from being rolled into the RAB 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; 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 periods different regulatory determinations will be relevant for determining the overall allowance for the years being considered. 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.

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 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 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.

### **Consideration of the overall efficiency of what is rolled into the RAB**

In the draft rule, the statement on the efficiency of capex to be rolled into the RAB is 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 draft 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 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.

## **9.7 Actual or forecast depreciation**

### **9.7.1 Analysis**

#### **Further work on the incentive effects of actual and forecast depreciation**

The changes to the NER that have been proposed by the AER aim to give it flexibility to choose to adopt either a high powered or low powered capex incentive. This would allow it to adopt the approach most appropriate taking into account a range of factors including other incentives and the circumstances of a NSP. The choice of depreciation approach is one part of the overall capex incentive framework, the objective of which is for the AER to ensure that only efficient capex is rolled into the RAB. As discussed above, it is desirable for the AER to have access to a range of options it can apply in

order to achieve this objective. Furthermore, it is appropriate for the AER to be accorded the flexibility to apply those options differently depending on the circumstances of a NSP.

The directions paper did not present a view on whether the AER should have discretion to use actual or forecast depreciation or whether a specific method should be prescribed in the NER. Instead, the Commission undertook to explore in more detail how the choice of depreciation affects a NSP's behaviour.<sup>333</sup>

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 percentage of revenue that a NSP is either up or down for changes in its spending relative to the allowance. The incentive power was calculated for asset lives of 10, 20, 30, 40 and 50 years using both forecast and actual depreciation for comparison.<sup>334</sup>

Figure 9.4 below illustrates the results of Economic Insights' modelling. The incentive power for each asset category is shown for each year of a 5 year regulatory period for two cases: Case 1 using actual capex and forecast depreciation (red bars); and Case 2 using actual capex and actual depreciation (blue bars).<sup>335</sup>

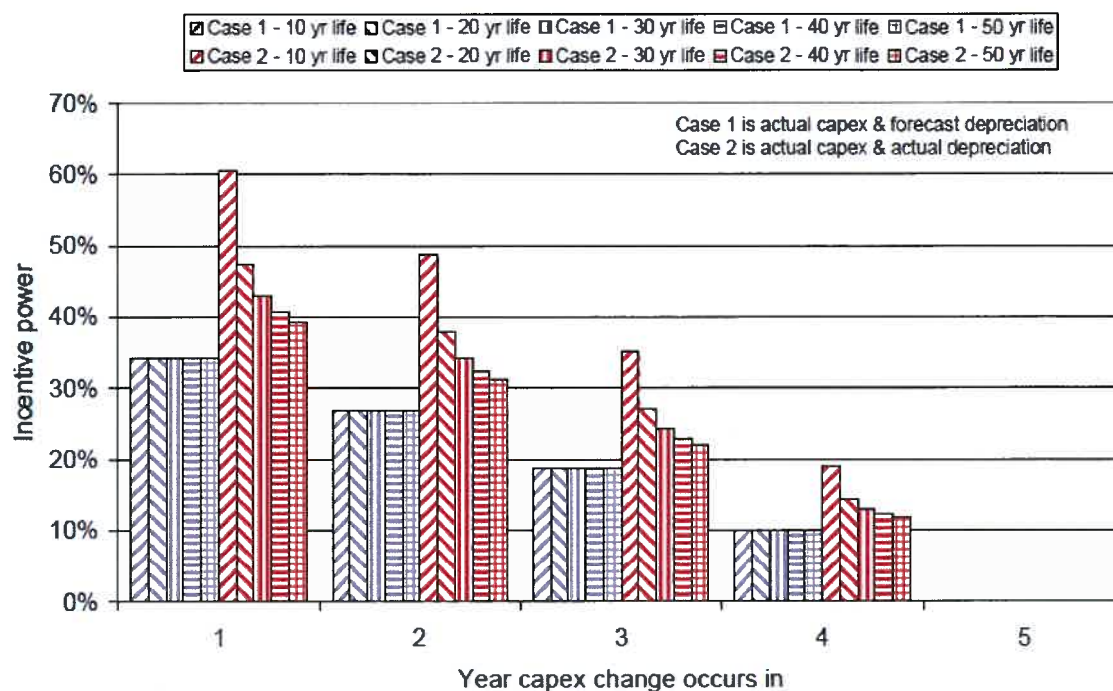
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<sup>333</sup> AEMC, Consolidated Rule Request – Economic Regulation of Network Service Providers, Directions Paper, 2 March 2012, p. 49.

<sup>334</sup> Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, pp. 14-15.

<sup>335</sup> Economic Insights also examined two further cases whereby the capex that is rolled into the RAB is based on the forecast as opposed to the current approach whereby all capex rolled into the RAB is based on the actual amount spent during the period. These additional scenarios were modelled for completeness in order to examine the full range of incentives on NSPs in relation to the roll forward model. The Commission is not currently considering changing the current approach with respect to capex.

**Figure 9.4 Capex incentive powers from using actual or forecast depreciation**



Source: Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, p. 20.

Three conclusions may be drawn from the figure above:

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. This is illustrated by the red bars being taller than the blue bars;
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. This is shown by the red bars being different heights for the same year and the blue bars being the same height. Since the red bars are highest for the shortest asset lives, a NSP will have a relatively stronger incentive to minimise capex relative to the allowance for those asset types using actual depreciation;
3. The incentive to make any savings relative to the allowance declines through the regulatory period and by year five results in no incentive to make savings.<sup>336</sup> This is shown by all the bars becoming smaller as the years progress and

<sup>336</sup> 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 (Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, p. 14).



becoming zero by year 5. This is true under both the actual and the forecast depreciation approach.

These modelling results confirm the theoretical assessment of the relative incentive effects of depreciation approaches and analyses put forward in submissions.<sup>337</sup> 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.<sup>338</sup>”

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.<sup>339</sup>”

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. However, it also stated that given the potential distortionary effects of an actual depreciation approach, it should be used sparingly where additional incentives are warranted and not likely to create significant distortions.

The AER should have the same flexibility in Chapter 6A to adopt actual or forecast depreciation as it does in Chapter 6. This is consistent with the overall approach on capex incentives, that the AER should have access to a range of tools that it can apply depending on the circumstances of the NSP. It is also consistent with harmonising Chapters 6 and 6A to the extent possible. The Commission also notes that nearly all stakeholders supported the AER having the same flexibility in transmission as it currently has in distribution.

### **Principles for the AER to consider in determining an approach to depreciation**

In the rule change process, the Commission has in general supported discretion for the AER coupled with principles the AER must take into account when exercising its discretion. This approach is also appropriate for depreciation. Indeed, Economic

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<sup>337</sup> ENA, Directions Paper submission, 16 April 2012, p. 33 and ENA, Directions Paper submission, Attachment C, 16 April 2012, p. 8.

<sup>338</sup> Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, p. 42.

<sup>339</sup> *Id.*, p. 33.

Insights has recommended this approach be taken.<sup>340</sup> Some stakeholders support the use of criteria to evaluate whether a particular approach is appropriate.<sup>341</sup> The importance of criteria was demonstrated by the recent Tribunal decision in which the AER's decision to apply actual depreciation to the Victorian DNSPs was appealed by the Victorian government and was rejected on the basis that the Minister failed to demonstrate that the AER had not followed the required procedures in making its decision.<sup>342</sup> Any principles applied should be the same in Chapter 6 as in Chapter 6A.

The choice of depreciation methodology that is made in a regulatory determination applies at the following reset when the RAB is rolled forward. It affects how much capex that is incurred during the period is rolled into the RAB at the end of the period. As a result, the choice of methodology affects the incentives on the NSP to incur capex efficiently during the period and is one tool that can be utilised to provide incentives to incur capex efficiently. There are also a number of other factors that will affect a NSP's incentives to incur capex efficiently during the period. It is therefore appropriate to consider these factors together when making a decision on the choice of depreciation methodology. The principles set out in the draft rule are intended to facilitate a bespoke analysis of the most appropriate depreciation approach for a NSP.

Therefore, the principles reflect 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. It is 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. It is also important 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.

Moreover, given the differing incentive rates for assets with economic lives of different lengths under the actual depreciation approach, the extent to which they are substitutable will affect whether it is appropriate to have these differing incentives.<sup>343</sup> This is because, should they be substitutable, it may distort investment decisions on input use which may ultimately impact consumers. For example, it may be more expensive to address demand management by investing in poles and wires (long life) instead of smart technologies (short life). Whether these are substitutable or not, the differing power of the incentive under an actual depreciation approach may independently affect the investment decision. It is therefore relevant to also consider

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<sup>340</sup> Id., p. iv.

<sup>341</sup> Jemena, Directions Paper submission, 16 April 2012, p. 24; ENA, Directions Paper submission, Attachment C, 16 April 2012, p. v.

<sup>342</sup> ACompT, *Application by United Energy Distribution Pty Limited [2012] ACompT 1*, 6 January 2012.

<sup>343</sup> Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012.

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 it is 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 objective of the analysis is to arrive at a decision that is consistent with the incentives for efficient capex under the overall regulatory framework whilst minimising any distortionary effects. The AER is required to set out in the capex incentive guidelines the manner in which it proposes to determine whether to use actual or forecast depreciation.

### **9.7.2 Guidance on draft rule**

The draft 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 a review 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. 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 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, 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.

## 9.8 Related party margins and capitalisation policy changes

### 9.8.1 Analysis

#### Further consideration of the problem

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

In the directions paper the Commission stated it would undertake further work to understand the strength of the additional incentive for NSPs to inefficiently incur capitalised related party margins, particularly if the higher related party margins are due to genuine higher costs. The Commission also acknowledged that there is a theoretical incentive for NSPs to reclassify opex as capex by changing their capitalisation policy during a regulatory period, although it considered that stronger capex incentives through an EBSS for capex for example might deal with this issue by removing the incentive to capitalise opex inefficiently.<sup>344</sup>

Following the directions paper the Commission engaged consultants (Covec) to explore the strength of any incentive that a NSP has to incur inefficient related party margins. Covec investigated and reported on a range of related party issues.

In particular, Covec developed a model to analyse the incentive to pay related party margins. The model allowed for different levels of ownership by the NSP of the related party and different fractions of the margin allowed by the regulator to enter the RAB. The results of the model show that when the 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.<sup>345</sup> However, Covec identified that at smaller ownership shares it is not financially beneficial to pay an inflated margin, even if there is full pass through of the margin into the RAB.<sup>346</sup> This is illustrated in Figure 9.5 below.

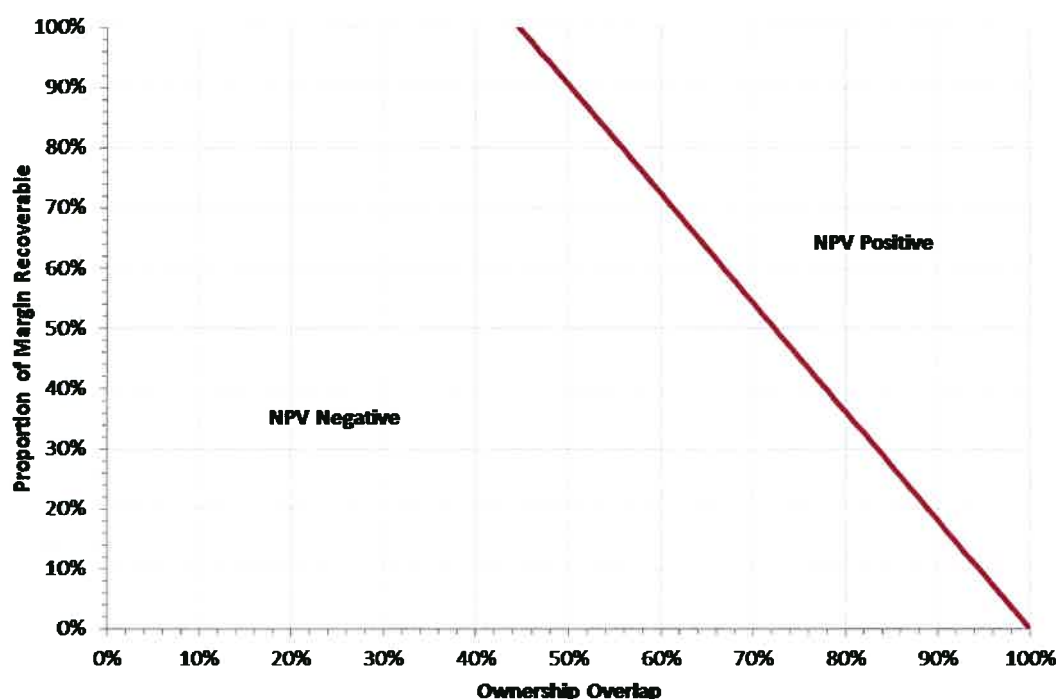
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<sup>344</sup> AEMC, Consolidated Rule Request – Economic Regulation of Network Service Providers, Directions Paper, 2 March 2012, pp. 57-58.

<sup>345</sup> Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers, Report for the AEMC*, 6 June 2012, p. iii.

<sup>346</sup> Ibid.

**Figure 9.5 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.

In addition to the modelling results, Covec identified that a driver for NSPs to engage related parties was economies of scale and scope.<sup>347</sup> Similarly, it noted that there may be tax advantages in engaging related parties but considered that the size of this incentive would be small.<sup>348</sup> It also noted that there is some risk that recent regulatory practice may deter otherwise efficient outsourcing to related parties. Covec considers that an ex post review of prudence and efficiency would provide an opportunity for the AER to mitigate the risk that NSPs may inflate related party margins.<sup>349</sup>

The modelling undertaken by Covec appears to confirm that there is a potential incentive for NSPs to incur inefficient related party margins. It shows that this can occur even where there are strong ex ante capex incentives on a NSP, such as through a capex sharing scheme. Also, as identified by the AER, strong capex incentives will not deal with the issue where a NSP spends less than its allowance overall but incurs inefficient related party margins.<sup>350</sup> The Covec modelling also shows that there is a potential incentive on NSPs to incur inefficient margins where there is less than 100 per cent joint ownership between the NSP and the related party.<sup>351</sup>

<sup>347</sup> Id., p. 18

<sup>348</sup> Id., p. 12.

<sup>349</sup> Id., p. iii

<sup>350</sup> AER, Directions Paper supplementary submission, 30 May 2012, p. 28.

<sup>351</sup> Covec, *Analysis of the Use of Related parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, p. 20.

In summary, it appears in theory that there is an issue in the sense that a NSP contracting with a related party in some circumstances could derive a NPV benefit compared to another NSP that does not, although conversely there are other circumstances when such an approach may be NPV negative. This incentive could encourage NSPs to enter into commercial arrangements that are not the most efficient. It is relevant that the AER and ESCV have both felt that there was a need for additional measures to address excessive related party margins. To encourage NSPs to use the most efficient business structure the Commission considers that this issue should be addressed.

### **Addressing the problem**

Given that stronger ex ante incentives through a capex sharing scheme will not fully deal with this issue the Commission considers that the issue should be dealt with by reviewing the capex after it is undertaken. It therefore proposes to give the AER discretion to reduce capex that would otherwise be rolled into the RAB by an amount that represents such part of the margin as would not have been paid if the arrangements to which the margin relates had been on arm's length terms. The AER should have this discretion regardless of whether the NSP spent more than its allowance overall or not. This is because a NSP may also gain from inflating related party margins where it spends less than its allowance overall. This is consistent with the capex factor in the NER that the AER must have regard to in determining the ex ante capex allowance.<sup>352</sup>

The AER should determine whether related party margins meet this test. Overall, a flexible or NSP-specific approach would be optimal, to recognise the differing incentive power in different circumstances. The AER's current approach, as described in the Covec report,<sup>353</sup> may lack flexibility to take account of NSP specific circumstances. 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 is an example of how this approach might be developed. The Commission proposes to require the AER to set out its approach in the capex incentive guidelines. This will 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.

The Commission accepts that there is a potential incentive for a NSP to change its capitalisation policy during a regulatory period so that they 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. At the same time, though, the requirements of statutory accounting may reduce somewhat the incentive or increase the costs of changing capitalisation policies. The incentive to

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<sup>352</sup> See for example clause 6.5.7(e)(9).

<sup>353</sup> Covec, *Analysis of the Use of Related parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, pp. i, 8-9.

change policies should be reduced if a capex sharing scheme brings closer the incentives to undertake efficient opex and capex. In addition there appears to be merit in the ENA's comment that the AER should retain the ability to calculate opex and capex efficiency gains under an EBSS in a manner that removes the effect of changes to the classification of expenditure.<sup>354</sup> However, as set out in section 9.5, although there are likely to be benefits in applying a capex sharing scheme it should be at the AER's discretion as to whether such a scheme is implemented. In addition, even if the AER were to develop and apply a capex sharing scheme this would not necessarily provide for an incentive power that was equal to the opex incentive power, although this is something that the AER would need to consider. Ex ante incentives alone will, therefore, not necessarily deal with this issue. In these circumstances 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 reduce the capex that would otherwise be rolled into the RAB by an amount that represents the opex that has been capitalised as a result of within-period changes to the NSPs capitalisation policy. The AER should have this discretion regardless of whether the NSP has spent more than its capex allowance overall or not. This is because a NSP may gain from changing its capitalisation policy where it spends less than its allowance overall. In general a NSP should be able to avoid having to capitalise opex 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 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 period could be delayed until the start of the next regulatory period.

### **9.8.2 Guidance on draft rule**

The draft rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to deal with inefficient related party margins. It is 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 is up to the AER to determine what the margin would have been if it considers the arrangements do not reflect arm's length terms. However, the AER is required to set out its proposed approach 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.

Similarly, the draft rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to reflect opex that was capitalised as a result of changes to the NSPs capitalisation policy during the regulatory 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

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<sup>354</sup> ENA, Directions Paper submission, 16 April 2012, p. 35.

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 draft rule requires an NSP to include in its regulatory proposal information on margins paid or expected to be paid in respect of arrangements that are not on arm's length terms and information on opex that has been capitalised by NSPs otherwise than in accordance with the policy submitted to the AER as part of the NSP's regulatory proposal. As a corollary, the draft rule requires 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.



## 10 Regulatory determination process

### Summary

- The NER prescribe the process by which the AER is to determine revenues and, in some cases, prices of NSPs. It also sets out the process for market participants in making submissions on each other's material and the AER's draft decision.
- In addition to the NER, the NEL sets out how the AER is to undertake its economic regulatory functions or powers. As a general rule, the NER do not prescribe matters that are already addressed in the NEL. The AER is also subject to various common law requirements that apply to the AER's decision-making processes.
- The process set out in the NER should be considered as the minimum requirement for stakeholder engagement. In the absence of any prescription in the NER on the regulatory determination process, the NSP and AER should be engaging with each other and other stakeholders.
- The Commission has taken a holistic approach to address broad issues with the current process. These issues relate to:
  - giving the AER and other stakeholders, including consumers and consumer representative groups, sufficient time to consider all relevant and significant material;
  - improving consumer engagement, especially earlier in the process; and
  - allowing the NSP sufficient time to prepare its revised regulatory proposal.
- Incremental changes have been made to the current regulatory determination process to clarify existing processes as well as to address the particular issues identified by the Commission. These changes aim to make the process more transparent and make all market participants engaged in the process more accountable.
- The following changes address the issue of improving consumer engagement:
  - the NSP providing a consumer-targeted overview paper with its regulatory proposal;
  - the AER publishing an issues paper outlining its preliminary key issues to assist the consumers to focus their resources; and

- the AER holding a public forum to allow consumers and other stakeholders to engage with the AER and NSP on the regulatory proposal and issues paper.
- The following changes address the issue of making the NSP more accountable:
  - requiring the NSP to identify to the AER specific confidentiality claims in its regulatory proposal;
  - requiring the AER to report such confidentiality claims on its website; and
  - requiring the AER to report on its website where it receives late or out-of-scope material from the NSP.
- The following changes address the issue of improving submissions and the submission consideration process:
  - extending the timeframe for the regulatory determination process by commencing it six months earlier;
  - increasing the time for the NSP to prepare its revised regulatory proposal; and
  - introducing a discretionary cross-submissions stage to target specific issues arising from submissions on the draft regulatory determination or revised regulatory proposal.
- The following changes address the issue of streamlining the framework and approach paper stage:
  - making the paper optional on particular matters that has been addressed in a previous framework and approach paper; and
  - clarifying and aligning the circumstances for changing the service classification and formulaic expression of the control mechanism for unforeseen circumstances.

## 10.1 Introduction

Regulatory decision-making involves thorough consideration of the regulated business' proposal.<sup>355</sup> It involves providing opportunities for the regulated business and interested stakeholders, including consumers and consumer representative groups, to make submissions to the regulator.<sup>356</sup> It also entails allowing reasonable

<sup>355</sup> This point was also made by the Commission in 2006. See AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 108.

<sup>356</sup> Ibid.

time for full and thorough analysis of the submissions and the regulator's intermediate decisions.<sup>357</sup> To facilitate this, the NEL sets out the manner in which the AER is to perform its economic regulatory functions or powers.<sup>358</sup> In addition, the NEL specifies the processes that the AER, NSP and other stakeholders are required to follow as part of the regulatory determination process.<sup>359</sup> A key to effective regulation is the reduction of regulatory risk by providing transparent and timely processes for regulatory determinations.<sup>360</sup> 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.<sup>361</sup>

### 10.1.1 Regulatory determination process

To reduce regulatory error under the current regulatory determination processes, all stakeholders are permitted to provide submissions at various points throughout the process. The AER is 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.<sup>362</sup> This does not provide other stakeholders and the AER sufficient time to scrutinise this material.

The AER proposes placing limitations on NSP submissions to address this issue. In particular, the AER has proposed rules that would prevent the NSP from making a late initial or revised regulatory proposal in the form of submissions.<sup>363</sup>

### 10.1.2 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 is 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.<sup>364</sup>

The AER proposes amendments to the NEL which would, amongst other things, provide the AER with the discretion to give such weight as it considers appropriate to

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357 Ibid.

358 Ibid.

359 Ibid.

360 Ibid.

361 Ibid.

362 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.

363 AER, Rule change request, Part B, 29 September 2011, p. 89.

364 Id., p. 90.

confidential information. This would apply in an initial or revised regulatory proposal, or in any submissions given to the AER.

### **10.1.3 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 proposes 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".

### **10.1.4 Chapter structure**

The remainder of this chapter is structured as follows:

- section 10.2 summarises the submissions received in response to the Commission's directions paper;
- section 10.3 outlines the general principles adopted by the Commission in addressing the problems identified with the regulatory determination process; and
- the following sections provide detailed analysis on specific matters with respect to:
  - late or out-of-scope submissions (section 10.4);
  - confidentiality claims in the regulatory proposal (section 10.5);
  - the mandatory issues paper and overview paper (section 10.6);
  - the cross-submissions stage (section 10.7);
  - the timing of the regulatory determination process (section 10.8); and
  - the framework and approach paper (section 10.9).

## 10.2 Submissions

### 10.2.1 Regulatory determination process

There is general support for commencing the regulatory determination process earlier, including extending the current timeframe.<sup>365</sup> Submissions varied in how much time should be allocated for commencing the regulatory determination process earlier.<sup>366</sup> However, there was also general disagreement on delaying the making of the final regulatory determination, especially due to the impact on subsequent and concurrent regulatory processes.<sup>367</sup> Other options proposed, including a mandatory issues paper and cross-submissions stage, received support from NSPs and other stakeholders.<sup>368</sup> However, the AER was concerned that these would either not provide any value or create administrative burden.<sup>369</sup>

The AER supports its original proposal to restrict submissions from the NSP to require a complete regulatory proposal upfront and to allow the AER and other stakeholders to consider the NSP's regulatory proposal.<sup>370</sup> Nevertheless, the AER is open to modifying its proposal if there are any inconsistencies with the NEL.<sup>371</sup>

Consumer representative groups also support the AER's proposal.<sup>372</sup> They generally do not consider any of the other options proposed in the directions paper would

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<sup>365</sup> AER, Directions Paper submission, 2 May 2012, pp. 62, 65-69; ENA, Directions Paper submission, 16 April 2012, pp. 63-65; ENERGEX, Directions Paper submission, 16 April 2012, pp.3-4; Ergon Energy, Directions Paper submission, 16 April 2012, pp. 15-16; Essential Energy, Directions Paper submission, 20 April 2011, pp.9-12; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 47-48; Grid Australia, Directions Paper submission, 16 April 2012, pp. 2-3, 12; Jemena, Directions Paper submission, 16 April 2012, pp. 47, 54; MEU, Directions Paper submission, 17 April 2012, pp.37-38.

<sup>366</sup> ENA, Directions Paper submission, 16 April 2012, p. 63; Grid Australia, Directions Paper submission, 16 April 2012, p. 12; Jemena, Directions Paper submission, 16 April 2012, p. 47.

<sup>367</sup> AER, Directions Paper submission, 2 May 2012, pp. 68-69; ENA, Directions Paper submission, 16 April 2012, p. 65; ENERGEX, Directions Paper submission, 16 April 2012, pp. 3-4; Ergon Energy, Directions Paper submission, 16 April 2012, pp. 15-16; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 47-48; MEU, Directions Paper submission, 17 April 2012, p.38; SA DMITRE, Directions Paper submission, 5 May 2012, p. 5.

<sup>368</sup> ENA, Directions Paper submission, 16 April 2012, pp. 63-66; ENERGEX, Directions Paper submission, 16 April 2012, pp.3-4; Ergon Energy, Directions Paper submission, 16 April 2012, pp. 15-16; Essential Energy, Directions Paper submission, 20 April 2011, pp.9-12; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 47-48; Grid Australia, Directions Paper submission, 16 April 2012, p. 12; Jemena, Directions Paper submission, 16 April 2012, 47, 54; MEU, Directions Paper submission, 17 April 2012, pp.37-38; SP AusNet, Directions submission, 16 April 2012, pp. 6-7; Vic DFI, Directions Paper submission, 16 April 2012, pp.13-14.

<sup>369</sup> AER, Directions Paper submission, 2 May 2012, pp. 65-69.

<sup>370</sup> *Id.*, pp. 65-66.

<sup>371</sup> *Ibid.*

<sup>372</sup> Consumer Action Law Centre, Directions Paper submission, 16 April 2012, p. 7; CUAC, Directions Paper submission, 16 April 2012, p. 4; EUAA, Directions Paper submission, 16 April 2012, pp. 33-34; MEU, Directions Paper submission, 17 April 2012, p. 37; PIAC, Directions Paper submission, 16 April 2012, p. 2; UnitingCare Australia, Directions Paper submission, 9 May 2012, p. 60.

directly address the AER's problem of receiving late submissions.<sup>373</sup> NSPs maintain their previous position from first round submissions that there are legitimate reasons for making late submissions.<sup>374</sup> As an alternative to the AER's approach, NSPs propose a non-rule based solution to address legitimate late submissions.<sup>375</sup>

### 10.2.2 Confidentiality claims

Most of the stakeholders who provided second round submissions on confidentiality claims maintained their positions from first round submissions. Consumer representative groups maintain their support for the AER proposal, as they agree with the AER's characterisation of the problem.<sup>376</sup> In addition to its original proposal, the AER proposes a "stop the clock" mechanism to allow it more time to consider confidentiality claims.<sup>377</sup>

NSPs continue to disagree with the AER's proposal and consider that the current arrangements are appropriately balanced and the AER should not be given more time.<sup>378</sup> They elaborate further on their previous first round submissions for a non-rule based approach, including proposing a confidentiality information protocol, principles for the protocol, and categorising confidentiality claims.<sup>379</sup>

### 10.2.3 Framework and approach

#### Need for a framework and approach paper

The AER supports the NSPs' previous proposal from first round submissions for making the framework and approach paper optional on particular matters, which would be triggered by either the AER or NSP.<sup>380</sup> However, some other NSPs consider that the framework and approach paper must be mandatory to avoid complications such as uncertainties associated with triggering its publication.<sup>381</sup> The MEU considers

<sup>373</sup> EUAA, Directions Paper submission, 16 April 2012, pp. 33-34; Public Interest Advocacy Centre (PIAC), Directions Paper submission, 16 April 2012, p. 2; UnitingCare Australia, Directions Paper submission, 9 May 2012, p. 60.

<sup>374</sup> ENA, Directions Paper submission, 16 April 2012, pp. 62-63; Ergon Energy, Directions Paper submission, 16 April 2012, pp. 15-16; Essential Energy, Directions Paper submission, 20 April 2011, pp. 10-11; Jemena, Directions Paper submission, 16 April 2012, pp. 51-53.

<sup>375</sup> ENA, Directions Paper submission, 16 April 2012, pp. 66-67; Jemena, Directions Paper submission, 16 April 2012, pp. 51, 55; SP AusNet, Directions Paper submission, 16 April 2012, pp. 5-6.

<sup>376</sup> Consumer Action Law Centre, Directions Paper submission, 16 April 2012, p. 7; EUAA, Directions Paper submission, 16 April 2012, pp. 33-34; MEU, Directions Paper submission, 17 April 2012, p. 38; PIAC, Directions Paper submission, 16 April 2012, pp.2-3; UnitingCare Australia, Directions Paper submission, 9 May 2012, pp. 59-60.

<sup>377</sup> AER, Directions Paper submission, 2 May 2012, p. 71.

<sup>378</sup> Ergon Energy, Directions Paper submission, 16 April 2012, p.16; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 49.

<sup>379</sup> ENA, Directions Paper submission, 16 April 2012, pp. 67-71.

<sup>380</sup> AER, Directions Paper submission, 2 May 2012, pp. 63, 73.

<sup>381</sup> ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 50-51.

that the framework and approach paper is still necessary to fix in and resolve specific matters earlier in the process.<sup>382</sup>

### **Control mechanism**

The AER states that the control mechanism should be fixed in the framework and approach paper.<sup>383</sup> On the other hand, the AER supports changing the formulaic expression that gives effect to the control mechanism for unforeseen circumstances subsequent to a framework and approach paper.<sup>384</sup> This is a view that has received support from NSPs.<sup>385</sup>

### **Threshold for changing service classification and formulaic expression of the control mechanism in regulatory determinations**

The AER maintains from its original proposal that the threshold for changing service classification in regulatory determinations should be for unforeseen circumstances.<sup>386</sup> This should also now apply to the formulaic expression that gives effect to the control mechanism.<sup>387</sup> Most NSPs consider that the AER's proposal creates uncertainty and that any such change should be based on persuasive evidence.<sup>388</sup> However, the joint submission of ETSA, CitiPower and Powercor consider that the current threshold of "good reasons" should be retained for service classification.<sup>389</sup> They consider that the formulaic expression of the control mechanism can be revisited because the AER currently does this.<sup>390</sup> The MEU, on the other hand, suggests that basing the threshold on unforeseen circumstances suggests the NSP does not understand its business.<sup>391</sup>

## **10.3 General principles**

### **10.3.1 Background**

In 2006, the AEMC considered that the regulatory determination process needs to be transparent and timely to provide all parties with a clearer understanding of their

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382 MEU, Directions Paper submission, 17 April 2012, pp. 56-57, 68-69.

383 AER, Directions Paper submission, 2 May 2012, p. 73.

384 Ibid.

385 ENA, Directions Paper submission, 16 April 2012, pp. 74-75; Ergon Energy, Directions Paper submission, 16 April 2012, p. 17; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 51.

386 AER, Directions Paper submission, 2 May 2012, p. 73.

387 Ibid.

388 ENA, Directions Paper submission, 16 April 2012, pp. 74-75; Ergon Energy, Directions Paper submission, 16 April 2012, p. 17.

389 ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 51-52.

390 Ibid.

391 MEU, Directions Paper submission, 17 April 2012, p. 69.

rights and obligations at the outset.<sup>392</sup> This promotes more efficient network investment, operation and service provision in the long term interests of consumers.<sup>393</sup>

Providing the NSP and stakeholders opportunities to make submissions to the regulator and providing for full and thorough decision-making by the regulator promotes transparency.<sup>394</sup> This transparency leads to reduced regulatory risk and error, and decreases the administrative costs of regulation.<sup>395</sup> Applying time constraints to the process also contributes to timely and efficient regulatory decision-making.<sup>396</sup>

The environment for the economic regulation of network services has changed since the AEMC's Chapter 6A rule determination. In 2008, the merits review process was introduced into the NEL. In addition, the MCE Standing Committee of Officials (SCO) made Chapter 6 of the NER for economic regulation of distribution network services. The volume and scope of material being assessed by the AER, and consulted upon with stakeholders, has also increased over time. AER decisions have, as a consequence, increased in length.

As a result of this changed environment, the current timeframe creates challenges for stakeholders to scrutinise the NSP's material, and for the AER to assess all relevant material and make a decision. Consumer representative groups also cannot engage effectively in the regulatory determination process. This changing environment requires adjustment to the regulatory determination process.

### **10.3.2 Key objectives underpinning the regulatory determination process**

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;

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392 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. xxi.

393 Ibid.

394 Id., p. 33.

395 Ibid.

396 Ibid.



- 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.

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.

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 NER, including the draft 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.<sup>397</sup> The New Zealand Commerce Commission has made use of this type of discretion. Further, the NER only provide a framework towards effective engagement; they it should be seen as a minimum in terms of the level of engagement. The extent of interaction between the regulated business, the regulator 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.

As a general rule, the Commission has not prescribed in the NER requirements where a regulatory requirement already exists via the NEL or common law. The Commission considers that prescribing 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 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.

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<sup>397</sup> 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.

### 10.3.3 Options chosen

In addressing the broader issues identified in the directions paper, the Commission has decided 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.<sup>398</sup>

These options enhance the transparent and timely processes for regulatory determinations, and increase the robustness of regulatory decision-making. They also address the broader issue of providing all stakeholders with sufficient time and improving stakeholder engagement during the regulatory determination process. They are each discussed in turn below.

## 10.4 Late or out-of-scope submissions

### 10.4.1 Analysis

The AER has 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. To resolve this, the AER proposed placing limitations on NSP submissions, including preventing the NSP from making submissions and limiting it to providing regulatory proposals. However, 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

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<sup>398</sup> 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.

the quantity of late material has an adverse effect on the ability of interested parties to be engaged with the regulatory determination process.

### **Inconsistency with the NEL**

The Commission has decided not to accept the AER's proposal to restrict the NSP's provision of material during the regulatory determination process. This is 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 considers that the AER's proposal to restrict the NSP from making submissions in respect of the regulatory determination before it is made creates an inconsistency with sections 16 and 28ZC of the NEL. On this basis, the Commission notes that the AER has retracted from its original proposal and is open to making modifications to its proposal to avoid any inconsistencies with the NEL.<sup>399</sup>

### **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.

One New Zealand Commerce Commission case related to the input methodologies proposed to be used to regulate the price and quality of air services under the *Commerce Act 1986* (New Zealand). The regulated businesses filed a number of late submissions close to the end of the regulatory process, which was several months after submissions had closed.<sup>400</sup> These submissions were provided in another part of the consultation stage addressing a different matter which made them out-of-scope. This was also late with respect to the previous consultation stage. The Commerce Commission decided to reject those submissions.<sup>401</sup>

The regulated business sought judicial review of the Commerce Commission, and the High Court of New Zealand found in favour of the regulator.<sup>402</sup> The court held that there was no legitimate expectation created for the Commerce Commission to consider late submissions.<sup>403</sup> This is because there was no "clear, unambiguous and unqualified" representation from the Commerce Commission that it would have regard to late submissions.<sup>404</sup> It was also held that the Commerce Commission made no error in not considering the late submissions.<sup>405</sup> This is because it made no procedural error in determining the input methodologies under the legislation and there was no material

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399 AER, Directions Paper submission, 2 May 2012, p. 66.

400 *Wellington International Airport Limited v Commerce Commission* HC WN CIV-2011-485-1031 [21 December 2011], [278]-[293].

401 *Ibid.*

402 *Ibid.*

403 *Ibid.*

404 *Ibid.*

405 *Ibid.*

new element in the late submissions.<sup>406</sup> The Commerce Commission was also deemed to only be required to have regard to views received in the timeframes that the regulator sets.<sup>407</sup> The court's finding has set the precedent for the Commerce Commission if similar situations arise in the future.

The AER currently has the discretion as the regulator to not accept such submissions from the NSP or any other stakeholder.<sup>408</sup> The Commission understands 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.<sup>409</sup> The Commission encourages the AER where appropriate to utilise its existing powers as 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 has decided a better approach would be for the AER to report on any late or out-of-scope submissions it receives from a NSP. This will not preclude such material from being considered by the AER. However, 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. It should allow stakeholders, including consumers, to identify those NSPs that may be taking advantage of the regulatory process. At the same time, it would not prevent the AER taking into account submissions or further material from NSPs where this is justified and the AER has sufficient time to take it into account. 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.<sup>410</sup>

The Commission considered some other options proposed to address the limited timeframe, but decided to not accept these. These relate to:

- delaying the making of the final regulatory determination;
- "stopping the clock" for assessing an incomplete regulatory proposal;

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406 Ibid.

407 Ibid.

408 ENA, Consultation Paper submission, 8 December 2011, p. 57.

409 *Application by EnergyAustralia* [2009] ACompT 8, [257].

410 Commencing the regulatory determination process earlier and extending the current timeframe are described in section 10.8 of this draft rule determination.

- creating non-binding guidelines to address legitimate late submissions;
- applying a pecuniary penalty against the NSP who submits late submissions; and
- prescribing less weight to be placed on confidentiality claims in the regulatory proposal.

With respect to the option of delaying the making of the final regulatory determination process as a result of receiving a late submission from the NSP, the Commission decided not to proceed with this approach. This is because it would result in a significant administrative burden on other stakeholders. For instance, there would be flow-on effects on the annual pricing process for retailers and jurisdictional regulators. It may also be disproportionate to the problem identified.

The AER proposed a "stop the clock" mechanism to allow the AER to wait for information from a NSP in order to assess an incomplete or a deficient regulatory proposal.<sup>411</sup> However, as previously considered by the AEMC in 2006, there is benefit in maintaining a fixed timeframe for completion of the process.<sup>412</sup> This will also help the NSP to provide its best proposal, and allow for greater certainty and reduce delays. The Commission maintains its 2006 view by continuing the practice of specifying the timeframe for milestones within the regulatory determination process. Balanced with a specified timeframe, some flexibility will continue to be given to the AER to vary the time according to the individual circumstance. For example, not setting a time limit for the making of the draft regulatory determination will allow the AER some flexibility to obtain sufficient information before making the draft regulatory determination.

The ENA proposes non-rule based solutions including earlier engagement between the AER and NSP, and non-binding guidelines for addressing legitimate late submissions based on a set of principles.<sup>413</sup> The Commission commends the NSPs' participation in the rule change process by proposing some solutions towards resolving the identified problems. The Commission encourages NSPs to continue proactively engaging with the AER and other stakeholders, especially consumer representative groups, to improve how they interact with each other. The practices promoted by the NSPs should already be occurring consistent with the obligations on the AER under section 16 of the NEL.

The CUAC proposes the implementation of a pecuniary penalty against the NSP for making late submissions.<sup>414</sup> However, the making of such a rule is prohibited under section 36 of the NEL.

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<sup>411</sup> AER, Directions Paper submission, 2 May 2012, p. 67.

<sup>412</sup> AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 114.

<sup>413</sup> ENA, Directions Paper submission, 16 April 2012, pp. 66-67.

<sup>414</sup> CUAC, Directions Paper submission, 16 April 2012, p. 4.

#### 10.4.2 Guidance on draft rule

If the AER receives a late or out-of-scope submission from a NSP, the Commission's draft rule requires the AER to make available on its website from a NSP 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; and<sup>415</sup>
- an indication of the amount or length of that information that it considers to be late or out-of-scope.

The purpose of this draft rule is to publicise the fact that the NSP has made a submission to the AER which the AER considers to be either late or out-of-scope. By making this public, it should discourage the NSP and other NSPs from making such submissions in the future unless the information contained in them is necessary. It also allows the NSP to understand what the AER considers to be late or out-of-scope. Finally, 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.

#### 10.5 Confidentiality claims in the regulatory proposal

##### 10.5.1 Analysis

###### Background

In the AEMC's Chapter 6A rule determination, the AEMC considered that efficient and effective regulation requires the provision of accurate, timely and relevant information.<sup>416</sup> In making its decision on the treatment of confidential information, the AEMC balanced the need for:

- timely and accurate information, and stakeholder access to information by which the AER makes its decision; versus
- administrative cost and burden in providing that information, and protection of confidential information that would commercially harm the TNSP or third parties.<sup>417</sup>

The AEMC considered in 2006 that it was essential to provide a degree of transparency with respect to the contents of all submissions considered by the AER in making its decision. It also considered that the NSP should have the opportunity to respond to

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<sup>415</sup> For instance, the summary may simply cross refer to that information as contained in the submission.

<sup>416</sup> AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 113.

<sup>417</sup> Ibid.

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<sup>166</sup> Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

comments contained in submissions, in particular those critical of a NSP.<sup>418</sup> Therefore, the AEMC specified in the NER for the AER to be given the discretion to give lesser or no weight to confidential submissions.<sup>419</sup>

### **AER's existing powers**

In general, the Commission maintains the view it set out in the directions paper. 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. For example, if detailed cost forecasts for different aspects of a project were made public this may hamper a subsequent competitive procurement process. However, the Commission considers it unlikely that all aspects of an initial or revised regulatory proposal could legitimately be claimed to be confidential. This is partly because the NSP is a monopoly business and does not therefore compete directly with other businesses.

There also appears to be scope for information to be aggregated where concerns about confidentiality for more detailed aspects of information are present. On this basis, it 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 considers 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 respect of these discretionary powers, the AER indicates that the current timeframe sometimes makes it infeasible to apply the public benefits test under section 28ZB of the NEL.<sup>420</sup> However, the AER also indicates that its internal processes are being

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<sup>418</sup> Id., p. 121.

<sup>419</sup> Ibid.

<sup>420</sup> AER, Response to AEMC questions, 2 February 2012, p. 7.

improved to allow it sufficient time to make use of this discretionary power.<sup>421</sup> The AER notes that extending the regulatory determination timeframe may assist the AER in assessing large confidentiality claims and applying section 28ZB of the NEL.<sup>422</sup> The Commission considers that an additional six months to the current timeframe as discussed in section 10.8 should allow the AER more time to consider confidentiality claims in a regulatory proposal. However, the AER considers that extending the timeframe would not address the problem of a NSP making blanket and unsubstantiated confidentiality claims.<sup>423</sup> 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**

NSPs propose a categorisation of confidentiality claims to assist the AER in assessing confidentiality claims.<sup>424</sup> They propose the following categories:

- confidential contractual terms;
- market sensitive cost inputs;
- information provided by a third party on a confidential basis;
- proposed strategic property acquisitions;
- planning for negotiation of industrial agreements;
- proprietary information of a NSP or a third party;
- information which if made public may jeopardise security of the network or NSP's ability to effectively plan and operate its network; and
- information which identifies the personal affairs of individuals.<sup>425</sup>

The Commission considers 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. There may be other categories of confidentiality claims for information not listed which legislation would still require the AER to protect from being disclosed.<sup>426</sup>

To provide clarity on how confidentiality claims in regulatory proposals should be presented to the AER, the Commission proposes to require the AER to develop and

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421 Ibid.

422 AER, Directions Paper submission, 2 May 2012, p. 71.

423 Ibid.

424 ENA, Directions Paper submission, 16 April 2012, p. 71.

425 Ibid.

426 *Competition and Consumer Act 2010 (Cth)* s. 44AAF.



consult on guidelines with respect to this. The guidelines would specify the manner in which the NSP is to make confidentiality claims in its regulatory proposal, which may include categories of confidential information. The guidelines may also include how the NSP should identify the confidential information and the type of information that the NSP wishes to have disclosed. However, the guidelines would not prevent the NSP from making confidentiality claims. Its purpose is to assist the AER when it receives confidentiality claims from the NSP.

Further, by establishing guidelines which clarify the manner in which NSPs are to make their confidentiality claims, NSPs will have a better understanding of the AER's requirements. It will also make NSPs become more accountable when they make confidentiality claims in regulatory proposals. In addition, the administrative burden that would have been placed on the AER in addressing confidentiality claims should be reduced. For instance, the AER would be able to sort through the confidentiality claims more quickly and understand what it has to focus on. This would mean the time pressures on the AER would be alleviated and allow the AER to make use of its existing powers more efficiently.

In addition to the guidelines, the draft rule requires 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 will allow the public to have an understanding as to the proportion of material that has been claimed to be confidential. As a comparison to other NSPs' claims of confidentiality, a comparative proportion of material that the AER has previously received from other NSPs claiming to be confidential will also be published on the AER's website.

### **Interaction with interested parties**

NSPs have proposed a non-rule based solution to the issues raised in respect of confidential information in the form of a confidential information protocol.<sup>427</sup> This may include a limited disclosure agreement between the NSP and an interested party, as has been utilised in the telecommunications industry.<sup>428</sup> The Commission supports any initiative that aims to improve stakeholder engagement, without the need for prescription in the NER.

With the introduction of the NSP overview paper, it would be the appropriate place to require the NSP to explain whether and, if so, how it has engaged with consumers. The AER could use this information to assist it in determining whether it should take a stricter approach in assessing the confidentiality claims from the NSP. For instance, a consumer representative group may be given access by the NSP to a confidential document prior to the submission of the regulatory proposal. On this basis, the AER may be able to test the probative value of the document with that consumer representative group. This could assist the AER in determining how much weight to place on the document.

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<sup>427</sup> ENA, Directions Paper submission, 16 April 2012, p. 70.

<sup>428</sup> Ibid.

The Commission considers setting out the process for addressing confidentiality claims as discussed above will encourage NSPs to become more disciplined in only making genuine confidentiality claims. It will also result in the identification of confidential information to the AER more clearly. This in turn will reduce the administrative burden on the AER to test confidentiality claims. Other stakeholders will also benefit from a more transparent process and have a greater opportunity to access relevant information. Overall, this facilitates as much testing and scrutiny of the initial or revised regulatory proposal as possible, while upholding legitimate claims of confidentiality by NSPs. This will lead to a more well-balanced and robust decision-making process.

### 10.5.2 Guidance on draft rule

As noted earlier, to promote adherence to a process for addressing confidentiality claims, the draft rule requires the AER to issue guidelines. This will set out the manner in which the NSP makes confidentiality claims in its regulatory proposal, which may include identifying relevant categories of confidential information. The guidelines would be consulted upon in accordance with the standard consultation procedures for guidelines in the NER. The NSP and other stakeholders will then have an opportunity to clarify the requirements for making confidentiality claims in regulatory proposals.

Once the guidelines are in place, the NSP will be 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 or wishes to have disclosed. Based upon this information, the AER would be able to determine the comparative proportion of material that has been claimed as confidential with regard to other NSPs. The AER would then report on its website that a confidentiality claim has been made. Other information on the website would 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 would 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 its submission to demonstrate the proportion of material from NSPs that it has previously received claiming to be confidential.<sup>429</sup> This is reproduced and shown in Table 10.1. 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.

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<sup>429</sup> AER, Directions Paper submission, 2 May 2012, p. 71.

**Table 10.1 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 draft rule for confidentiality claims with respect to initial or revised regulatory proposals, the Commission considers that the same rules could also be applied to the pricing methodologies and to submissions in general.<sup>430</sup> 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.

## 10.6 Mandatory issues paper and overview paper

### 10.6.1 Analysis

#### Issues paper

Consumer representative groups seek 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. The LMR Panel has also taken a similar view that there are weaknesses in the regulatory determination process for consumer and user participation.<sup>431</sup> As a monopoly business, incentives need to be placed on the NSP to continually take into account consumers' current and future interests, preferences and requirements, including improvements to consumer welfare.<sup>432</sup>

The Commission considered in its directions paper the option to establish a mandatory issues paper during the time between the regulatory proposal and close of submissions

<sup>430</sup> Pricing methodologies are submitted with the regulatory proposal in transmission.

<sup>431</sup> LMR Panel, *Review of the Limited Merits Review Regime*, Stage One Report, Report for the SCER, 29 June 2012, p. 45.

<sup>432</sup> Ibid.

on the regulatory proposal. The Commission considered that it would be for the benefit of stakeholders, including consumer representative groups.

Currently, an issues paper is optional under the NER.<sup>433</sup> However, the Commission understands that this process has never been utilised in practice.

A potential explanation for the issues paper not being used by the AER is the current limited timeframe between the regulatory proposal and close of submissions on the regulatory proposal. The AER suggests that this time should be extended to reflect the time and resources if an issues paper is required.<sup>434</sup> The Commission recognises the current time constraints, and considers that additional time should be provided to the AER to prepare this paper.

The AER also considered that the issues paper should continue to be optional, as it may not add value to the regulatory determination process.<sup>435</sup> The Commission notes that the use of an issues paper is not unusual in regulation. Other jurisdictional regulators have used the paper in their regulatory processes.<sup>436</sup> The issues paper allows for preliminary considerations of the AER to be identified upfront. It also allows resource-limited stakeholders, such as consumer representative groups, to focus on specific issues. The Commission shares the view of the Vic DPI that the issues paper may result in a reduction of the volume of NSP material which stakeholders will have to consider.<sup>437</sup> By imposing an obligation on the AER to identify preliminary issues which it considers to be relevant, stakeholders will be guided into focusing on specific areas of interest in the NSP material. It will also reduce the need for stakeholders to unnecessarily become immersed in the other NSP material. In turn, the AER is not limited to considering other issues when making its determination.

The identification of these preliminary issues will assist all stakeholders to make better use of their resources to focus on particular matters when preparing their submissions on the regulatory proposal. It will 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 endorses the use of an issues paper.

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<sup>433</sup> NER clauses 6.9.3(b) and 6A.11.3(b).

<sup>434</sup> AER, Directions Paper submission, 2 May 2012, p. 67.

<sup>435</sup> Ibid.

<sup>436</sup> For example: ERA, *Western Power's Proposed Revisions to the Access Arrangement for the Western Power Network*, Issues Paper, 7 November 2011, p. 2; ESCOSA, *ETSA Utilities' Capital and Operating Expenditure Submission 2005-2010*, Issues Paper, June 2004, p. 3; ESCV, *Electricity Distribution Price Review 2006*, Issues Paper, December 2004; IPART, *Review of regulated retail tariffs and charges for electricity 2010-2013*, Issues Paper, July 2009; Office of the Tasmanian Economic Regulator (OTTER), *Declaration of Distribution Services and Terms of Reference*, Issues Paper, November 2006; Queensland Competition Authority (QCA), *2005 Electricity Distribution Review*, Issues Paper, September 2003, p. 4.

<sup>437</sup> Vic DPI, Directions Paper submission, 16 April 2012, p. 13.

Given its importance, an issues paper should be made mandatory. This will also help to place a discipline for all parties involved to discuss the AER's preliminary views earlier in the process.

In terms of the time requirement, the Vic DPI provided a comparison between the AER regulatory determination process and the ESCV regulatory process which included publication of an issues paper.<sup>438</sup> It took the ESCV approximately two months from the date of receiving the regulatory proposal to publish the issues paper. Using this as a guideline for providing adequate time without creating an administrative burden, the existing regulatory determination process timeframe could be extended to accommodate an additional 40 business days. The issues paper will therefore be required to be published by the AER within 40 business days after the AER receives the NSP's regulatory proposal.

### **Overview paper**

Alongside the issues paper, the Commission considers that there is a need for the NSP's regulatory proposal to be easier for consumers, including consumer representative groups, to understand. To promote this, the Commission has decided that an overview paper should be provided by the NSP. The paper would be subject to preliminary examination together with the regulatory proposal.

A difficulty identified in submissions, especially from consumer representative groups, is the resource intensive nature of the regulatory determination process. Part of this relates to the volume of information provided in the NSP's regulatory proposal. Just on the initial regulatory proposal alone, Table 10.2 illustrates the size that other stakeholders would have to consider for a given regulatory determination process.<sup>439</sup>

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<sup>438</sup> Id., pp. 13-14.

<sup>439</sup> This excludes the confidential information and any other accompanying information.

**Table 10.2 Total page count for initial regulatory proposals submitted to the AER**

Region	Segment	Regulatory period	Total page count
New South Wales/Australian Capital Territory	Distribution	2009-14	1049
	Transmission	2009-14	128
Queensland	Distribution	2011-15	892
	Transmission	2012-17	131
South Australia	Distribution	2010-15	286
	Transmission	2008-13	138
Tasmania	Distribution	2012-17	323
	Transmission	2009-14	187
Victoria	Distribution	2011-15	1886
	Transmission	2008-14	421

As can be seen in Table 10.2, the total number of pages in initial regulatory proposals varies between regions. This is because of the number of NSPs and type of segment that are being considered as part of the regulatory determination process. With the addition of information that would accompany these regulatory proposals, it creates a further burden 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 a right to address any of their concern 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 is 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 will help to promote better engagement by the NSP with consumers, including consumer representative groups. It will also 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.<sup>440</sup>

### **Public forum**

The Commission considers 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.

The Commission understands that the AER currently holds a public forum following the publication of the regulatory proposal, which involves the NSP and AER presenting to interested stakeholders. The Commission also recognises that the AER has a Customer Consultative Group which helps provide the AER with advice on matters affecting consumers. The Commission welcomes any other informal engagement between the NSP and AER with stakeholders.

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.

## **10.6.2 Guidance on draft rule**

### **Issues paper**

The Commission has decided to require the AER to publish an issues paper. The purpose of the paper will be 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 would not be precluded from considering other issues when making its regulatory determination. Therefore, the issues paper would not be an exhaustive review of the proposal or contain a complete list of the matters that the regulator would consider in making its final decision.

The issues paper will be 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 should still be able to 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 will be affected. The other milestones in the regulatory

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<sup>440</sup> LMR Panel, *Review of the Limited Merits Review Regime, Stage One Report*, Report for the SCER, 29 June 2012, p. 46.

determination process will not be contingent on the date that the issues paper is published.

The deadline for submissions on the issues paper and regulatory proposal will be required to be no earlier than 60 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 100 business days after receipt of the regulatory proposal.<sup>441</sup> The additional time for submissions on the regulatory proposal takes into account the introduction of the issues paper and submissions associated with that paper.

Further, to allow the AER to address a potential increase in submissions as a result of the issues paper, an additional 20 business days will be included as part of the overall regulatory determination process. This also accounts for the additional time that the AER would need to prepare its draft regulatory determination.

Submissions on the issues paper will be due at the same time that submissions on the regulatory proposal are due. This is to reflect 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 will need to explain how the NSP has engaged with electricity consumers in preparing its regulatory proposal. The paper will also provide a summary of the regulatory proposal for electricity consumers. In this way, the issues paper will act as a "map" to the regulatory proposal and help 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, it would be expected that the NSP will provide an explanation for any material differences between these two amounts.

Given that consumers will need to be able to easily access the paper, the issues paper will be a standalone document provided with the regulatory proposal. This means that the language in the paper should be plain language and should 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

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<sup>441</sup> This time also takes into account the 40 business days for the AER to publish its issues paper after receipt of the regulatory proposal.



the information required in the overview paper, the AER can utilise a regulatory information instrument.

### **Public forum**

The Commission will be making the convening of the public forum on the NSP's regulatory proposal and the AER's issues paper mandatory. It will be required to be held within 20 business days after the AER publishes its issues paper on the NSP's regulatory proposal.

## **10.7 Cross-submissions stage**

### **10.7.1 Analysis**

The AER has 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 understands that the AER has used its discretion at times to consult informally with interested parties prior to making a final regulatory determination.

The Commission considers a formal discretionary cross-submissions process may alleviate some of these problems. The New Zealand Commerce Commission uses a cross-submissions stage as part of its regulatory process. It 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. For example, the Commerce Commission allowed for a cross-submissions stage on its process and issues paper in one of its regulatory processes.<sup>442</sup> 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.<sup>443</sup> This second cross-submissions stage occurred immediately after close of 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.

A criticism of the cross-submissions stage is that it could create an additional administrative burden on the AER to consider an additional volume of material as a

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<sup>442</sup> The regulatory process was with respect to input methodologies for default price-quality paths with respect to electricity distribution and gas pipeline services. 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.

<sup>443</sup> New Zealand Commerce Commission, *Draft Input Methodologies for Default Price-Quality Paths*, Consultation Paper, 15 June 2012, p. 5.

result of the process.<sup>444</sup> Another criticism is that it may disincentivise the NSP from providing a complete revised regulatory proposal and submissions upfront within the current timeframes.<sup>445</sup> These two concerns could be mitigated by giving the regulator the discretion to initiate the cross-submissions stage. These concerns can be further mitigated by limiting the scope of the cross-submissions stage to specified matters that have been raised during first round submissions.

The Commission is of the view that providing the NSP and other stakeholders with an opportunity to respond to each other's submissions on specified matters will likely increase the opportunity for all to comment. It will 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.

Making the cross-submissions stage discretionary and limited in scope will reduce the risk that NSPs treat this stage as an opportunity to submit a late revised regulatory proposal. It also gives 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.

### **10.7.2 Guidance on draft rule**

The Commission has decided to allow for a cross-submissions stage in the NER. The AER will have the discretion to decide whether or not the cross-submissions stage will be 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 would be unnecessary. This is because the AER did not consider it necessary with respect to the revised regulatory proposal. The AER would have the discretion to limit the scope of the cross-submissions stage. The scope would be 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 would allow at least 15 business days for submissions after the invitation for submissions is published.

## **10.8 Timing of the regulatory determination process**

### **10.8.1 Analysis**

In the Chapter 6A rule determination, the timeframe for the regulatory determination process was limited to 11 months. The AEMC's intention was to promote efficient and timely regulatory decision-making. However, as described earlier in this chapter, the

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<sup>444</sup> AER, Directions Paper submission, 2 May 2012, p. 68.

<sup>445</sup> Ibid.

environment for economic regulation of network services has changed since the Chapter 6A rule determination and 11 months appears to be inadequate.

As noted in sections 10.4 to 10.6 in this draft rule determination, new additions to the regulatory determination process will require consequential changes to the existing 11-month regulatory determination process timeframe.

In addition, NSPs have proposed for the time for the NSP to prepare its revised regulatory proposal to be extended. In setting the current 30 business day timeframe in 2006, the AEMC considered that this would be sufficient for the NSP. It was considered that this reflected the limited scope of matters that would be addressed in the revised regulatory proposal. It was also considered that this would provide the discipline to submit in a timely manner. However, the Commission accepts that a lack of resources over the Christmas to New Year period, if applicable, may mean that the 30 business days are insufficient. That said, the NSP must still provide its revised regulatory proposal within a specified timeframe and limit these to matters identified by the AER in the draft regulatory determination. The NSP should not circumvent the existing requirements.

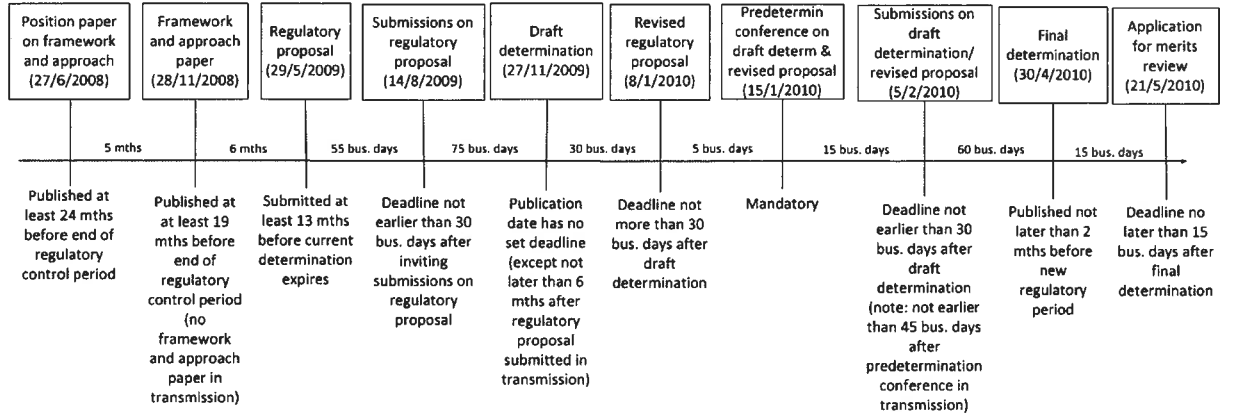
Recognising the burden placed on the NSP, the Commission will allow for an additional 15 business days to the current 30 business day period in which the NSP must submit its revised regulatory proposal.<sup>446</sup> This should provide the NSP with a more reasonable opportunity to prepare and submit a complete revised regulatory proposal. The timeframes have been calibrated to address the Christmas to New Year period problem for the NSP in preparing its revised regulatory proposal under both the financial year and calendar year timeframes. It has also been adjusted for other stakeholders in responding to the revised regulatory proposal.

A total additional 120 business days, or approximately six months, will be required for the overall regulatory determination process timeframe. This is to account for the extension in time for existing stages in the process and the addition of new stages. The Commission does not consider it appropriate to reduce this additional period as proposed in submissions. This is because it would most likely reduce the timeframe for the AER to make its decisions, which would likely reduce the robustness of the AER's decisions. As a result, a NSP will now 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.

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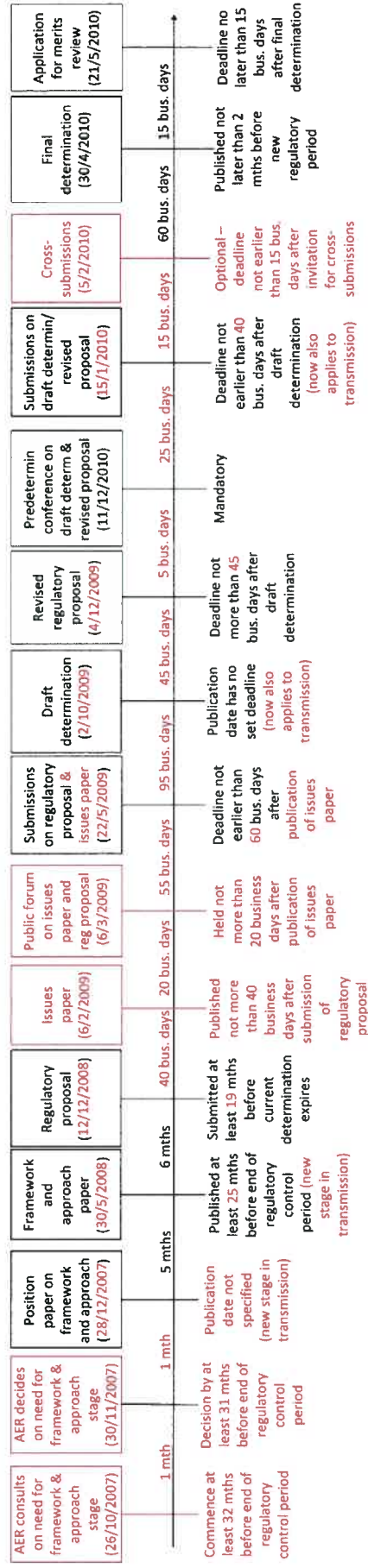
<sup>446</sup> The Commission notes that NSPs propose an additional period of between 10 to 15 business days to prepare their revised regulatory proposals.

**Figure 10.1 Example of the current regulatory determination process applicable to DNSPs**



Note: the dates used in Figure 10.1 are hypothetical and are only used to illustrate the differences between the existing timeframe in this figure and the new timeframe shown in Figure 10.2. The diagram is unique to distribution. Where there are differences with transmission, this has been noted in the diagram.

**Figure 10.2 Example of the new regulatory determination process applicable to DNSPs and TNSPs**



Note: changes to the current regulatory determination process are highlighted in red text.

A concern with commencing the regulatory determination process earlier is the reduction in accuracy of forecasts for expenditure. This means that the information is more likely to be out-dated when the final regulatory determination is made. However, commencing the regulatory determination process earlier will allow for additional processes to promote further stakeholder engagement and transparency. It will also allow for more time for the existing processes, which should lead to more robust decision-making, more comprehensive and timely submissions, and reduce late material. For these reasons, the Commission considers that the benefit of commencing the regulatory determination process earlier by six months outweighs the risk of less accurate and available information for forecasts.

A comparison with some other jurisdictions and their regulatory processes would suggest that the new AER regulatory determination timeframe is now substantially longer than in those jurisdictions.<sup>447</sup> On the other hand, the AER regulatory determination process is still shorter than the standard 24 month timeframe provided by Ofgem in Great Britain.<sup>448</sup> However, it is somewhat misleading to compare the overall timeframe for the AER regulatory determination process with other jurisdictions, given the differences between the regulatory processes. For example, the degree of prescription is quite extensive with respect to the regulatory determination process for the AER, including statutory deadlines, while Ofgem has almost no prescription on any aspect of the determination process.<sup>449</sup> Another difference includes the scope of the regulatory determination such as determining the cost of capital which is required for the AER regulatory determination, but not required in New Zealand.<sup>450</sup> There are also historical reasons for the differences, noting that the economic regulation of network services was transferred from various jurisdiction-specific regulatory processes into a single NEM-wide regulatory process.<sup>451</sup>

In reviewing the timeframe of the existing regulatory determination process, the Commission considered aligning the regulatory determination process timeframes for transmission and distribution. For consistency, the Commission has decided to make consequential changes where it does not consider there should be any difference and should have a minimal impact on stakeholders. As a result the changes include:

- removing the deadline for the making of the draft regulatory determination for transmission. There is currently no such deadline for distribution. In contrast, the

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<sup>447</sup> The 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.

<sup>448</sup> 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.

<sup>449</sup> The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 12.

<sup>450</sup> Ibid.

<sup>451</sup> Id., paragraph 27.

deadline for the publication of the draft regulatory determination in transmission is currently set for no later than six months after the regulatory proposal has been submitted. Removing this deadline allows 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, this is currently 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. For distribution, this is currently set at no earlier than 30 business days after the date specified by the AER with respect to the predetermination conference on the draft regulatory determination.

Given that the above consequential changes are not set to specific dates, the AER will still have some flexibility in adjusting the timeframe for specific milestones as it currently does. However, in continuing to allow for flexibility in changing those timeframes, the AER will still be constrained to meeting the final deadline for publishing the final regulatory determination.

### **10.8.2 Guidance on draft rule**

Commencing the regulatory determination process 120 business days earlier, as can be seen in Figure 10.1 and Figure 10.2, will allow for:

- 40 business days for the AER to prepare the issues paper following receipt of the NSP's regulatory proposal;
- 20 business days for the AER to hold a public forum following the issues paper;
- an additional 20 business days for the AER to prepare its draft regulatory determination;
- an additional 15 business days for the NSP to submit its revised regulatory proposal;
- an additional 10 business days for other stakeholders to consider the NSP's revised regulatory proposal and draft regulatory determination; and
- 15 business days for a cross-submissions consultation stage.

## **10.9 Framework and approach paper**

### **10.9.1 Analysis**

#### **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.<sup>452</sup> 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. The Commission maintains this position.

Specifying the circumstances when a framework and approach paper is necessary will provide stakeholders with a clear understanding of when the framework and approach would need to be consulted upon. Stakeholders' submissions would also be taken into account prior to the AER making the decision whether or not to proceed with a framework and approach paper.

NSPs also proposed that it should be either the AER or NSP that triggers the framework and approach paper. The MEU, on the other hand, suggested that it should be a tripartite approach and include other stakeholders. Upon further consideration, the Commission considers 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 will also apply to transmission. Moreover, the draft rule omits the provisions in Chapter 6A that relate to submission guidelines. This is because all of the information requirements of submission guidelines as set out in NER clause 6A.10.2 can be met under a regulatory information instrument.

### **Incentive schemes**

The Commission notes the AER's concern that consulting on incentive schemes in the framework and approach paper would be unnecessary and inefficient. However, the Commission maintains its position from the directions paper to retain incentive schemes as part of the framework and approach paper. This is because there has previously been reasonable stakeholder engagement on incentives schemes. Even so, by not requiring a new framework and approach paper with respect to such incentive schemes unless there is to be a change in the way they are applied, the AER's concern should be alleviated. The Commission considers this provides the appropriate balance between flexibility and administrative efficiency on the one hand, and certainty in the framework and approach paper stage on the other.

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<sup>452</sup> 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.