RULE CHANGE

Australian Energy Market Commission

RULE DETERMINATION

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

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

Rule Proponents

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

29 November 2012

For and on behalf of the Australian Energy Market Commission

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About the AEMC

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

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Executive Summary

Overview

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

This final determination sets out the amendments that have been made to the NER and the NGR and the Commission's reasons for these amendments. It also sets out the transitional arrangements to implement the new rules. This final determination and the final rules reflect the Commission's position as foreshadowed in final position paper published on 15 November 2012.

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

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

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

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

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

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

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

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

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

Changes to address problems identified

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

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

Rate of return

Overall approach

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

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

Given the capital intensity of energy networks, the rate of return is one of the key determinants of the network prices that consumers pay. The nature of the energy

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

network sector requires service providers to make significant investments in assets over time to maintain and improve their networks. The rate of return allows service providers to attract the necessary funds from capital markets for these investments and service the debt they incur in borrowing the funds.

Common framework

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

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

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

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

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

Guidelines

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

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

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

Return on debt

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

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

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

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

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

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

Capital expenditure incentives (electricity)

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

The tools will include:

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

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

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

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

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

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

- the power of the incentive to incur capital expenditure efficiently declines during a regulatory period; and
- capital expenditure above the allowance is not subject to any regulatory scrutiny which means that there is a risk that expenditure above the allowance may be inefficient.

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

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

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

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

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

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

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

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

Capital expenditure and operating expenditure allowances (electricity)

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

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

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

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

This reflects the obligation that all public decision makers have to justify their decisions. In addition, the NER do not place any restrictions on the analytical techniques that the AER can use to scrutinise and, if necessary, amend or substitute the

NSP's capital expenditure or operating expenditure forecasts. From a practical perspective the NER reflect the approaches of other regulators.

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

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

Regulatory determination process

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

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

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

The changes include:

- lengthening the regulatory determination process to commence four months earlier, for both electricity distribution and transmission NSPs. This will provide time for the AER to prepare and publish a mandatory issues paper and hold a public forum. It will also provide time for a cross submissions stage later in the process, if required;

- the application of an optional framework and approach paper as part of the electricity transmission and distribution regulatory determinations processes. This document can be used, where necessary, to settle a number of issues prior to regulatory proposals being submitted. Examples include information that needs to be provided by the NSP, and the capital expenditure incentive package that the AER proposes to apply to the NSP; and

- improving transparency and accountability by requiring NSPs to nominate to the AER the reasons why it classifies material as confidential. The AER will be required to publish a report of the NSP making confidentiality claims as well as indicating the proportion of material that the NSP claims to be confidential.

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

Differences between draft rules and final rules

The final rules substantially reflect the draft rules, although there are some changes. Key differences include:

- clarification of the drafting of the return on debt factors;

- in respect of precluding any capital expenditure from being rolled into the RAB for overspends, it may only be applied for capital expenditure undertaken in regulatory years that commence after the capital expenditure incentive guidelines have been published;

- the powers of the AER to interrogate and amend expenditure proposals have been further clarified (clauses 6.12.3(f) and 6A.13.2(a) have been deleted entirely);

- the obligation on NSPs to comply with AER expenditure forecasting methodologies has been adjusted so that NSPs may instead provide expenditure assessment information required by the AER separate to their regulatory proposal;

- the new regulatory process has been shortened by two months (meaning it will only be four, rather than six months, longer than at present);

- the framework and approach process may be triggered by a NSP and not just by the AER; and

- the contingent project threshold has been changed to $30 million or 5% of the annual revenue requirement / maximum allowed revenue (whichever is higher).

Transitional arrangements

The Commission has included transitional arrangements in the final rules to enable the regulators to apply the new rules as soon as possible. This will allow the benefits of the new rules to flow through to consumers more quickly.

Transitional arrangements are required due to overlap between the timing of guidelines required under the new rules and that of upcoming regulatory processes, which must follow the guidelines. Transitional arrangements are included in the final rules for both electricity and gas. As well as allowing the new rules to be applied as soon as possible, the transitional arrangements are designed to minimise the resourcing burden on stakeholders and minimise price volatility.

Transitional arrangements will apply to regulatory processes until mid-2016, when Aurora and Powerlink are due to submit regulatory proposals. Different transitional arrangements have been designed for different service providers, and in general, the scale of the transitional arrangements reduces as time progresses.

Consumer engagement and participation

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

They include requiring:

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

Drivers for effective regulation

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

- the effective application of the NER and NGR by the regulator and review body; and
- the effective corporate governance of the NSPs providing services which are subject to economic regulation.[7]

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

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

The interpretation and application of the rules by the regulator is crucial. This final rule determination provides examples and illustrations of how the rules could be interpreted and applied to address problems that exist currently, as well as how their application could adapt when the circumstances change. In drafting the final rules, the Commission liaised with the AER regularly to be as certain as possible that the rules are correct, clear, and able to be applied by the AER, consistent with the Commission's position. The AER has reviewed the final rules and in its view, the final rules can be applied by the AER, consistent with the Commission's final position as set out in this final determination. The next section discusses the role of merits review in effective application of the NER and NGR.

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

Merits review

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

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

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

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

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

The Commission supports the need for accountability of the regulator through some form of merits review. Outcomes for consumers are likely to be improved if the proposed changes in the LMR Panel report to encourage a greater focus on objectives and overall outcomes by the review body are implemented. However, this final rule determination and the final rule proceed on the basis of the merits review arrangements existing at this point in time. As noted by the LMR Panel final report, to the extent that the merits review arrangements change, there may also need to be further rule changes to align the rules with the changes to the NEL and NGL regarding issues such as the definition of a reviewable decision.

Contents

1 Network regulation rule change requests

1.1 Rule change requests

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

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

- For natural gas: the rate of return provisions in the National Gas Rules (NGR).

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

1.2 Rationale for the rule change requests

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

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

- capital expenditure and operating expenditure allowances (electricity) – the AER referred to restrictions under the NER on its ability to interrogate and amend the capital expenditure (capex) and operating expenditure (opex) forecasts of NSPs and the requirement that the regulator must accept a forecast if it reasonably reflects certain criteria listed in the NER. The AER considered that the NER invite upwardly biased forecasts and limit its ability to interrogate and amend forecasts provided by NSPs;

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

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

- capex incentives (electricity) – the AER considered that there are problems with the current NER in respect of capex incentives. This is because they provide for all actual capex incurred within a regulatory control period to be rolled into the regulatory asset base (RAB) regardless of whether or not the capex allowed for in the determination was efficient. This roll forward model, in the AER's view, creates incentives for NSPs to incur more than efficient levels of capex;

- rate of return (electricity and gas) – the AER's electricity and gas rule change requests referred to the problems associated with having different rate of return frameworks for electricity distribution, electricity transmission and gas. In the AER's view these frameworks have required repeated assessments of similar arrangements and evidence for each determination or access arrangement process, creating an administrative burden. For gas, the AER stated that the NGR create uncertainty in that they do not specify a particular framework for determining the rate of return;

- cost of debt (electricity and gas) – the AER stated that the current approach to assessing the cost of debt has become difficult to apply under changing financial market conditions. The EURCC also considers this approach is problematic in the case of electricity, along with the lack of a differential cost of debt for state-owned and privately-owned NSPs; and

- regulatory determination process (electricity) – the AER has raised a number of process issues that largely concern the ability of stakeholders to engage effectively in the regulatory determination process. For example, NSPs provide submissions on their own regulatory proposals. In the AER's view this may result in stakeholders having insufficient time to consider additional material from the NSP.

1.3 Solutions proposed in the rule change requests

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

- capex and opex allowances – the AER proposed amendments to the NER to set its own estimate of capex and opex, using a range of inputs;

- capex incentives – the AER proposed for inclusion in the NER a sharing mechanism that would apply to any expenditure above the regulatory allowance. 60 per cent of this expenditure above the allowance would be rolled into the RAB for the next regulatory control period, with the remainder excluded from that asset base and funded by shareholders. It also proposed being given the discretion in transmission to determine whether to adopt forecast or actual depreciation; and to disallow capex for related party margins and as a consequence of capitalisation policy changes;

- rate of return – the AER proposed a single framework for electricity and gas which most closely aligns with the current framework for electricity transmission set out in Chapter 6A of the NER; that is, the outcomes of periodic rate of return reviews must apply and cannot be departed from in subsequent determinations and access arrangements made before the next rate of return review. The AER would also amend the NER and the NGR to provide it with increased discretion in how to determine certain individual parameters forming part of the rate of return and would remove the need for persuasive evidence before amending them. For gas in particular, the AER proposed that the NGR would prescribe that the rate of return would be calculated as a nominal post-tax vanilla weighted average cost of capital, using the capital asset pricing model to determine the return on equity. This means the rate of return provisions for electricity and gas would be in line;

- cost of debt - the AER proposed that the methodology for setting the debt risk premium should be included in the periodic rate of return reviews undertaken by the AER, rather than being prescribed in the NER. The EURCC proposes a new rules-prescribed methodology for calculating the cost of debt, having regard to the "actual debt costs" of electricity NSPs. The return on debt for state-owned electricity NSPs would be determined differently to non-state owned NSPs; and

- regulatory determination process - the AER considered that aspects of the current regulatory determination process under the NER could be improved to enable more timely submission and consideration of material by all relevant stakeholders prior to the AER making its decisions.

1.4 Consultants

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

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

- Professor Stephen Littlechild, Professor George Yarrow - assistance in the area of capex and opex allowances, capex incentive and regulatory process;

- Strategic Finance Group Consulting (SFG) - assistance on the rate of return including a specific report return on debt methodologies and advice on issues raised in the draft rule determination.

- The Brattle Group (Brattle) – on approaches to assessing capex and opex forecasts;

- Covec - on related party margins;

- Economic Insights – on the use of actual and forecast depreciation; and
- Parsons Brinckerhoff – on capital expenditure practices of NSPs.

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

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

1.5 Commencement of rule making process and extensions of time

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

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

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

On 15 November 2012, the AEMC issued notices under section 107 of the NEL and section 317 of the NGL to extend the timeframe for making its final rule determination to 29 November 2012 in order to allow for additional consultation and analysis on transitional arrangements for its implementation. The Commission also published a final position paper on 15 November 2012. The final position paper stated the Commission's final position in relation to each of the matters raised in the rule change requests. The final position paper was intended to inform stakeholders at the earliest possible opportunity of the Commission's position in response to consultation on the draft rule determination while transitional arrangements to implement the changes were being finalised.

The Commission also published a version of the final position rule that reflected its conclusions and decisions as contained in this final position paper. The final position paper and the final position rule were not subject to consultation.

1.6 Consultation on rule change requests

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

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

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

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

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

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

This document represents the Commission's final rule determination on the network rule change requests under the NER and the NGR

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

2 Final Rule determination - electricity

2.1 Commission's final rule determination

In accordance with section 102 of the NEL the Commission has made this final rule determination in relation to the rules proposed by the AER and the EURCC as part of the consolidated rule change request.

The Commission has determined that it should not make the rule proposed by the AER and the EURCC, but rather, to make a more preferable rule.[11]

The Commission's reasons for making this final rule determination are set out in chapters 6 to 12.

The more preferable rule that the Commission has made (final rule) is attached to and published with this final rule determination. The final rule includes rules for transitional arrangements that will apply to certain NSPs to transition them into the new rules. The key features of the final rules are described in chapters 6 to 12 of this final rule determination.

2.2 Commission's considerations

In assessing the consolidated rule change request the Commission considered:

- its powers under the NEL to make the final rule determination;
- the consolidated rule change request;
- submissions received during initial consultation on the consolidated rule change request and following publication of the directions paper and draft rule determination;
- comments made by stakeholders as part of workshops and forums held as part of the consultation undertaken for the consolidated rule change request;
- consultants reports;[12]
- the ways in which the proposed rule will, or is likely to, contribute to the achievement of the national electricity objective (NEO);
- discussion papers and reports published by the Limited Merits Review Panel;

11 Under section 91A of the NEL the AEMC may make a rule that is different (including materially different) from a market initiated proposed rule (a more preferable rule) if the AEMC is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates) the more preferable rule will or is likely to better contribute to the achievement of the national electricity objective.

12 Referred to in chapter 1.

- previous decisions of the Commission, including the 2006 Chapter 6A rule determination;[13]
- relevant documents published by the Ministerial Council on Energy (MCE) regarding the development of Chapter 6 of the NER; and
- relevant merits review decisions of the Australian Competition Tribunal (ACT).

There is no relevant MCE Statement of Policy Principles relating to the consolidated rule change request.

2.3 Commission's power to make the rule

The Commission is satisfied that the final rule falls within the subject matter about which the Commission may make rules as set out in section 34 of the NEL and in schedule 1 of the NEL. The final rule is, among other things, within:

- section 34(1)(a)(iii), as it relates to the activities of persons participating in the National Electricity Market (NEM) or involved in the operation of the national electricity system; and
- the matters set out in items 15-24 and 25-26I of schedule 1, as they relate to transmission and distribution system revenue and pricing.

2.4 Rule making test

2.4.1 NEO

Under section 88(1) of the NEL the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system."

For the consolidated rule change request the Commission considers that the relevant aspects of the NEO is the promotion of efficient investment in electricity services for

13 AEMC, Economic Regulation of Transmission Services, Rule Determination, 16 November 2006, Sydney.

the long term interests of consumers with respect to price. More particularly, efficient investment requires:

- there being a level of investment in network infrastructure so that safety and reliability standards are met in circumstances where consumers pay no more than is necessary for the network services they receive;
- the costs NSPs incur in providing network services to their customers reflecting efficient financing costs. This is to allow NSPs to attract sufficient funds for investment while minimising the resultant costs that are borne by consumers;
- the establishment of certain, robust and transparent regulatory environment. Investors will have more confidence and may be more likely to invest in monopoly infrastructure where the regulatory process is certain and robust, with appropriate checks and balances in place. Consumers will also have more confidence that the outcomes are better in such an environment; and
- regulatory certainty in the application of the improved and strengthened rules.

2.4.2 Assessment of the final rule against the NEO

The Commission is satisfied that the final rule will, or is likely to, contribute to the achievement of the NEO for the reasons set out below.

2.4.3 Rate of return

The final rule introduces a new framework for determining the rate of return. It provides that the allowed rate of return for a NSP must meet an objective related to the efficient financing costs of a benchmark efficient NSP with a similar degree of risk as that which applies to the NSP subject to the decision. The final rule provides the regulator with sufficient discretion on the methodology for estimating the required return on equity and debt components but also requires the consideration of a range of estimation methods, financial models, market data and other information so that the best estimate of the rate of return can be obtained overall that achieves the allowed rate of return objective.

The final rule also provides for the allowed rate of return to reflect changing circumstances so that the application of the framework should result in the best overall estimate of the rate of return in any case that is commensurate with efficient financing costs. This should ensure sufficient funds are attracted for network investment, while minimising costs for electricity consumers.

Approach to capex and opex

The final rule confirms the discretion the regulator has to review and scrutinise NSPs' capex and opex proposals to better achieve the objective that allowances set are efficient. The regulator can adopt a range of analytical techniques to determine the ultimate capex and opex allowances for a NSP. The final rule also provides for a suite of ex ante incentive mechanisms that could be used to encourage NSPs to incur only capex which is efficient. As NSPs are different the final rule provides the regulator with discretion to determine an appropriate capex incentive package for each NSP. As a final check, the final rule also provides for the regulator to undertake a review of past capex for efficiency.

This establishes a package of tools to allow the regulator to set efficient allowances in the first place, to establish an appropriate ex ante incentive regime to encourage efficient capex and finally, to undertake a review of past expenditure and to preclude inefficient expenditure being rolled into the regulatory asset base. This package should mean that only investment that is necessary is incurred and rolled into the asset base. This means that consumers will pay as part of their network charges only for investment that was necessary to provide network services to them.

Regulatory determination process

The final rule makes a number of changes to the process for making determinations. It provides more time for consumers and other stakeholders to participate meaningfully in the regulatory determination process, as well as giving the regulator more time towards the end of the process to consider material presented to it. The final rule also provides for increased transparency and accountability regarding confidentiality claims over material submitted as part of the process.

The regulatory determination process changes increase the likelihood of better overall outcomes, as there should be more time to consider information, and resolve issues at an earlier stage where possible. This will help increase confidence in the regulatory determination process.

Transitional arrangements

The final rule includes transitional rules that allow the regulator and NSPs to apply the new rules as soon as possible with minimal administrative cost and regulatory uncertainty. This should mean consumers will benefit as soon as possible from efficient pricing outcomes consistent with their long term interests.

2.4.4 Implementation costs

The final rule provides for a range of significant changes to Chapters 6 and 6A of the NER. There will be implementation costs for NSPs and other stakeholders, including consumers, in adjusting to these changes. For the regulator there will be implementation costs as it develops the guidelines and schemes necessary for the successful application of this package of rules.

Having said this, the Commission is of the view that these costs are minor when compared with the potential benefits associated with the final rule. The costs will be outweighed by the outcomes of the determination process.

2.4.5 AEMO's declared network functions

Under section 91(8) of the NEL the Commission may only make a rule that has effect with respect to an adoptive jurisdiction if satisfied that the proposed rule is compatible with the proper performance of Australian Energy Market Operator's (AEMO) declared network functions. The final rule is compatible with AEMO's declared network functions because it is not related to and does not affect these functions.

2.5 More preferable rule

Under section 91A of the NEL, the AEMC may make a rule that is different (including materially different) from a market initiated proposed rule (a more preferable rule) if the AEMC is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates), the more preferable rule will, or is likely to, better contribute to the achievement of the NEO.

Having regard to the issues raised by the proposed rules in the consolidated rule request, the Commission is satisfied that the final rule will, or is likely to, better contribute to the achievement of the NEO than the proposed rules for the following reasons:

- the final rule encourages more holistic, overall decision-making by the regulator. In particular, the rate of return provisions and the capex incentive provisions of the final rule allow the AER to adopt an approach that is consistent with the achievement of a specified objective without prescribing the precise approach which the AER must adopt;

- the final rule provides the regulator with discretion to consider the changing circumstances of each NSP, and make decisions on a case by case basis so that the best outcomes can be achieved - at the same time, the regulator must do so in an accountable and transparent manner. For the rate of return provisions, the final rule also enables the regulator to have regard to any changes in financial market conditions that could have a positive or negative impact on a NSP's rate of return at the time of its decision;

- the final rule amends the regulatory process so that it commences earlier and includes additional steps. This gives the regulator more time to make better decisions and other stakeholders more time to participate in the process more effectively; and

- the final rule includes transitional arrangements to allow application of the new rules to all NSPs as soon as possible.

Chapters 6 to 11 explain in greater detail how the Commission considers that the final rule is likely to better contribute to the achievement of the NEO than the rules proposed in the consolidated rule request. Chapter 12 discusses the rules on transitional arrangements.

The final rule also includes a number of provisions that are necessary or consequential (as permitted by section 91B of the NEL).

2.6 Other requirements under the NEL

In applying the rule making test in section 88 of the NEL, the Commission has taken into account the revenue and pricing principles (RPP) as required under section 88B of the NEL as the final rule relates to matters specified in items 15 to 24 and 25 to 26J of Schedule 1 to the NEL.

In respect of the transitional arrangements, the Commission has also taken into account five broad principles that, in its view, represent the most important considerations for the new rules. These principles include:

1. the final rules should apply to all service providers as soon as possible;

2. where any transitional arrangements are made regarding determination processes that require consultation, the arrangements should allow for sufficient time for stakeholder consultation;

3. the transitional arrangements should provide service providers with a reasonable opportunity to recover at least the efficient costs they incur in the provision of regulated services;

4. the transitional arrangements should be practicable having regard to the regulator's resourcing constraints, as well as the resourcing capacity of other stakeholders; and

5. the transitional arrangements should minimise the potential for one-off price shocks for consumers.

The Commission believes these five broad principles for transitional arrangements are consistent with the NEO and the RPP. The Commission has borne these principles in mind when assessing the various proposals that have been made about the form that the transitional arrangements should take.

The next section below explains how the RPP have been taken into account.

2.6.1 Recovery of efficient costs

Section 7A(2) of the NEL – a NSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing network services and in complying with a regulatory obligation or requirement or making a regulatory payment.

Rate of return

This principle requires that the rate of return reflects efficient financing costs necessary to attract sufficient investment capital to maintain a reliable electricity supply while minimising the cost to consumers. The rate of return must therefore only reflect efficient financing costs of a benchmark efficient NSP to ensure that the service provider can retain the benefits from adopting more efficient financing arrangements than assumed by the regulator, and consumers are protected if a service provider is inefficient in their financing practices.

Capex/opex allowances and capex incentives

A NSP's proposal must set out the NSP's capex and opex requirements for the regulatory period. While this final rule determination clarifies the discretion the regulator has to interrogate and amend a NSP's forecasts, it also confirms the significance of the NSP's proposal for the regulator's determination. In terms of capex incentives, any scheme implemented by the regulator is likely to allow an increase above a NSP's capex allowance (or at least be neutral) for an efficient NSP. In addition, any efficient costs of a NSP should be rolled into the RAB following a review of the efficiency of past capex by the regulator.

Regulatory determination process

The regulatory determination process changes increase the likelihood of better overall outcomes, as there should be more time to consider information, and resolve issues at an earlier stage where possible.

Transitional arrangements

In the context of transitional arrangements, the Commission has expressly considered the RPP on recovery of at least efficient costs as one of the key principles. The transitional arrangements have been put in place so that those NSPs that are in the process of preparing their regulatory proposals for the next regulatory period, or will be required to submit their regulatory proposals while the AER determines its approach to certain issues under the new rules, have certainty as to how the rules are to apply to them.

2.6.2 Effective incentives

Section 7A(3) of the NEL – a NSP should be provided with effective incentives to promote economic efficiency with respect to the services the NSP provides. The economic efficiency that should be promoted includes efficient investment in the systems used to provide network services, efficient provision of those services, and efficient use of the systems that provide those services.

Rate of return

Efficient outcomes in terms of investment, operation and use of network services are most likely to be obtained when the best estimate of the rate of return is obtained. Achievement of the overall allowed rate of return objective will promote effective incentives as the rate of return determined should be commensurate with benchmark efficient financing costs.

Capex/opex allowances and capex incentives

The combination of an appropriately set ex ante allowance for capex and a range of capex incentives (including a review of the efficiency of past capex) will create effective incentives to promote economic efficiency. In addition, the final rule gives the regulator the power to establish small scale incentive schemes to test innovative approaches to incentives.

Transitional arrangements

In order to create effective incentives that promote economic efficiency, the new rules apply to all NSPs as soon as possible. The transitional arrangements have been developed to progressively apply the new rules to NSPs as they approach their regulatory determinations for the next regulatory period. Different arrangements have been put in place for different NSPs, depending on when their next regulatory period begins. This means that improved incentives can be provided to NSPs going forward.

2.6.3 Charges for network services

Section 7A(5) of the NEL – the price or charge for the provision of a network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the network service.

Rate of return

Having regard to this principle involves the estimated rate of return being commensurate with the risks involved in providing the service, which is what is sought from the rate of return estimation process. This principle can best be met by obtaining the best possible rate of return estimate.

Capex/opex allowances and capex incentives

As described above, the regulator should take into account the NSP’s proposal as part of the process of setting expenditure allowances. In addition, the final rule clarifies the discretion the AER has in interrogating and amending the NSP’s proposal. Appropriately set capex and opex allowances should allow for a return commensurate with regulatory and commercial risks.

2.6.4 Economic costs and risks of potential for under and over investment

Section 7A(6) of the NEL – regard should be had to the economic costs and risks of the potential for under- and over-investment by a NSP in the systems used to provide network services.

Rate of return

If the rate of return estimate is set to the efficient required return, there will be no incentive for under- or over- investment. Such incentives for inefficient investment become more pronounced when the rate of return estimate differs from the efficient required return.

Capex/opex allowances and capex incentives

Capex and opex allowances that are set too high or too low can create the risk of under- or over- investment. By clarifying the discretions the regulator has, the final rule determination contributes to expenditure allowances that better reflect efficient costs. More effective capex incentive arrangements, including reviews of the efficiency of past capex, may also mitigate the risk of over-investment.

Regulatory determination process

The final rule provides more time for consumers and other stakeholders to participate meaningfully in the regulatory determination process, as well as giving the regulator more time towards the end of the process to consider material presented to it. This should better allow economic costs and investment risks to be brought to the attention of the regulator and considered.

Transitional arrangements

The transitional arrangements principles one and two encapsulate this RPP. By putting in place appropriate transitional arrangements to apply the new rules to NSPs as soon as possible, the regulator is given greater powers to achieve efficient outcomes. This could reduce the risk of potential over or under-investment.

2.6.5 Economic costs and risks of potential for under and over utilisation

Section 7A(7) – regard should be had to the economic costs and risks of the potential for under- and over-use of the networks used to provide network services.

Rate of return

If the rate of return estimate is set to the efficient required return, then prices are (by definition) set at the efficient level and there is no distortive effect on usage due to mis-pricing.

Capex/opex allowances and capex incentives

Capex allowances set to an efficient level allow an appropriate level of capex to be undertaken. This should also then allow networks to sustain the use that is made of them.

Transitional arrangements

Prices should not be distorted when moving from the previous rules to the new rules, unless the underlying economic costs of the NSPs change. The transitional arrangements seek to minimise the potential for one-off price shocks for consumers in this regard and therefore provide appropriate price signals to consumers.

3 Final Rule determination - gas

3.1 Commission's final rule determination

In accordance with section 311 of the NGL the Commission has made this final rule determination in relation to the rule proposed by the AER.

The Commission has determined that it should not make the rule proposed by the AER but rather to make a more preferable rule.[14]

The Commission's reasons for making this final rule determination are set out in chapters 6 and 7. The Commission's reasons for the transitional arrangements are discussed in chapter 13.

The more preferable rule that the Commission has made (final rule) is attached to and published with this final rule determination. The final rule includes rules for transitional arrangements that will apply to certain gas service providers to transition them into the new rules. The key features of the final rules are described in chapters 6 and 7 of this final rule determination. The Commission's reasons for the transitional arrangements are discussed in chapter 13.

3.2 Commission's considerations

In assessing the rule change request the Commission considered:

- its powers under the NGL to make the final rule determination;
- the rule change request;
- submissions received during initial consultation on the rule change request and following publication of the directions paper and draft rule determination;
- comments made by stakeholders as part of workshops and forums held as part of the consultation undertaken for the rule change request;
- consultants reports;[15]
- the ways in which the proposed rule will, or is likely to, contribute to the achievement of the national gas objective (NGO);
- discussion papers and reports published by the Limited Merits Review Panel;

14 Under section 296 of the NGL the AEMC may make a rule that is different (including materially different) from a market initiated proposed Rule (a more preferable rule) if the AEMC is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates), the more preferable rule will or is likely to better contribute to the achievement of the national gas objective.

15 Referred to in chapter 1.

- previous decisions of the Commission, including the 2006 Chapter 6A determinations;
- relevant documents published by the MCE regarding the development of Chapter 6 of the NER; and
- relevant merits review decisions of the ACT.

There is no relevant MCE Statement of Policy Principles relating to this rule change request.

3.3 Commission's power to make the rule

The Commission is satisfied that the final rule falls within the subject matter about which the Commission may make rules as set out in section 74 of the NGL; in particular section 74(1)(a)(i) and (ii) relating to access to, and the provision of, pipeline services and items 41, 49 and 50 of schedule 1 of the NGL relating to the building block approval and the AER's economic regulatory functions and powers.

3.4 Rule making test

3.4.1 NGO

Under section 291(1) of the NGL the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NGO. This is the decision making framework that the Commission must apply.

The NGO is set out in section 23 of the NGL as follows:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

For the rule change request the Commission considers that the relevant aspects of the NGO are the efficient investment in natural gas services for the long term interests of consumers with respect to price. Efficient investment requires that the costs gas service providers incur in providing services to their customers should reflect efficient financing costs. This is to allow gas service providers to attract sufficient funds for investment while minimising the resultant costs that are borne by consumers.

3.4.2 Assessment of the final rule against the NGO

The Commission is satisfied that the final rule will, or is likely to, contribute to the achievement of the NGO because the final rule provides that the allowed rate of return for a benchmark efficient gas service provider must meet an objective related to the efficient financing costs of a gas service provider with a similar degree of risk as that which applies to the gas service provider subject to the decision. The final rule also provides the regulator with sufficient discretion on the methodology for estimating the required return on equity and debt components but also requires the consideration of a range of estimation methods, financial models, market data and other information so that the best estimate of the rate of return can be obtained overall that achieves the allowed rate of return objective..

The final rule also provides for the allowed rate of return to reflect changing circumstances so that the application of the provisions of the rule should result in the best overall estimate of the rate of return in any case, reflecting efficient financing costs.

The final rule also includes transitional rules that allow the regulator and gas service providers to apply the new rules as soon as possible with minimal administrative cost and regulatory uncertainty. This should mean consumers to will benefit as soon as possible from efficient pricing outcomes consistent with their long term interests.

All of these factors should allow sufficient funds to be attracted for network investment, while minimising costs for gas consumers, thereby promoting efficient investment which is also in the long term interests of gas consumers.

3.4.3 Implementation costs

The final rule provides for a range of significant changes to the rate of return provisions of the NGR. There will be implementation costs for gas service providers and other stakeholders, including consumers, in adjusting to these changes. For the regulator, there will be implementation costs as it develops the rate of return guideline necessary for the successful application of the final rule.

Having said this, the Commission is of the view that these costs are minor when compared with the potential benefits associated with improving the process for determining the allowed rate of return. The costs will be outweighed by the outcomes of this improved determination process.

3.5 More preferable rule

Under section 296 of the NGL, the AEMC may make a rule that is different, including materially different, from a market initiated proposed rule (a more preferable rule) if the AEMC is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed rule, to which the more preferable rule relates, the more preferable rule will, or is likely to, better contribute to the achievement of the NGO.

Having regard to the issues raised by the proposed rule, the Commission is satisfied that the final rule will, or is likely to, better contribute to the achievement of the NGO than the proposed rule for the following reasons:

- the final rule gives primacy to an overall rate of return objective. This objective is directly linked to the NGO by focussing on estimating a rate of return required by a benchmark efficient entity;

- the final rule requires the regulator to take a more holistic approach in estimating the return on equity and debt and the overall allowed rate of return;
- the final rule provides the regulator with discretion to use the best approach to estimating return on equity and return on debt to meet the overall rate of return objective on a case by case basis, but at the same time it must do so in an accountable and transparent manner;
- the final rule allows the regulator to have regard to any changes in financial market conditions that could have a positive or negative impact on a gas service provider's rate of return at the time of its decision;
- the final rule includes a requirement for the development and periodic review of rate of return guidelines to provide an interactive process between regulator, gas service provider, consumers and other stakeholders about the best approaches to estimating the rate of return; and
- the final rule includes transitional arrangements to allow application of the new rules to all gas service providers as soon as possible.

Chapters 6 and 7 explain in greater detail the respects in which the Commission considers that the final rule is likely to better contribute to the achievement of the NGO than the proposed rule. Chapter 13 discusses the rules on transitional arrangements.

The final rule also includes a number of provisions that are necessary or consequential (as permitted by section 297 of the NGL).

3.6 Other requirements under the NGL

As required under section 293 of the NGL, the Commission has also taken into account the revenue and pricing principles (RPP) as the final rule relates to item 41 of schedule 1 of the NGL.

The RPP have been taken into account as follows:

- Section 24(2) – a gas service provider should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing reference services and in complying with a regulatory obligation or requirement or making a regulatory payment. This principle requires that the rate of return reflects efficient financing costs necessary to attract sufficient investment capital to maintain a reliable natural gas supply while minimising the cost to consumers. The rate of return must therefore only reflect efficient financing costs of a benchmark efficient gas service provider to allow the service provider to retain the benefits from adopting more efficient financing arrangements than assumed by the regulator, and consumers are protected if a service provider is inefficient in their financing practices.
- Section 24(3) – a gas service provider should be provided with effective incentives to promote economic efficiency in investment in, and the operation

and use of, the pipeline for the provision of pipeline services. Efficient outcomes in terms of investment in, and the operation and use of, pipeline services are most likely to result when the best estimate of the rate of return is obtained.

- Section 24(5) – the reference tariff charged for a reference service should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service. Having regard to this principle involves the estimated rate of return being commensurate with the risks involved in providing the service, which is what is sought from the rate of return estimation process. This principle can best be met by obtaining the best possible rate of return estimate.

- Section 24(6) – regard should be had to the economic costs and risks of the potential for under- and over-investment by a gas service provider in a pipeline that is used to provide pipeline services. If the rate of return estimate is set to the efficient required return, there will be no incentive for under- or over-investment. Such incentives for inefficient investment become more pronounced when the rate of return estimate differs from the efficient required return.

- Section 24(7) – regard should be had to the economic costs and risks of the potential for under- and over-utilisation of a pipeline that is used to provide pipeline services. If the rate of return estimate is set to the efficient required return, then prices are by definition set at the efficient level and there is no distortive effect due to mis-pricing.

In respect of the transitional arrangements, the Commission has also taken into account five broad principles that, in its view, represent the most important considerations for the new rules. These principles include:

1. the final rules should apply to all gas service providers as soon as possible;

2. where any transitional arrangements are made regarding determination processes that require consultation, the arrangements should allow for sufficient time for stakeholder consultation;

3. the transitional arrangements should provide service providers with a reasonable opportunity to recover at least the efficient costs they incur in the provision of regulated services;

4. the transitional arrangements should be practicable having regard to the regulator's resourcing constraints, as well as the resourcing capacity of other stakeholders; and

5. the transitional arrangements should minimise the potential for one-off price shocks for consumers.

The Commission believes these five broad principles for transitional arrangements are consistent with the NGO and the RPP. They have been taken into account as follows:

- Section 24(2) – the Commission has expressly considered the RPP on recovery of at least efficient costs as one of the key principles. The transitional arrangements have been put in place so that those gas service providers that are in the process of preparing their regulatory proposals for the next regulatory period, or will be required to submit their regulatory proposals while the regulator determines its approach to rate of return as part of the preparation of the rate of return guidelines, have certainty as to how the rules are to apply to them.

- Section 24(3) – in order to create effective incentives that promote economic efficiency, the new rules apply to all gas service providers as soon as possible.

- Section 24(6) – the transitional arrangements principles one and two encapsulate this RPP. By putting in place appropriate transitional arrangements to apply the new rules to NSPs as soon as possible, the regulator is given greater powers to achieve efficient outcomes. This could reduce the risk of potential over or under-investment.

- Section 24(7) – prices should not be distorted when moving from the previous rules to the new rules, unless the underlying economic costs of the gas service providers' change. The transitional arrangements seek to minimise the potential for one-off price shocks for consumers in this regard and therefore provide appropriate price signals to consumers.

The Commission has borne these principles in mind when assessing the various proposals that have been made about the form that the gas transitional arrangements should take.

4 Commission's reasons

4.1 Introduction

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

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

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

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

4.2 Summary of assessment of issues

The rule change requests raised four broad areas of problems with the rules, as set out in chapter 1. Taking each in turn, the Commission draws the following conclusions as set out below.

4.2.1 Rate of return

Overall framework

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

There is a strong case for a common framework under the NER, including as between transmission and distribution, and NGR for setting the rate of return. A common framework can minimise any risks of distortions in capital allocation or investment decisions between the electricity and gas sectors, although the framework contemplated here would provide scope for the regulator to consider the different characteristics of NSPs in each sector when determining a rate of return for each NSP.[16]

Under the new approach the regulator must determine a rate of return (the allowed rate of return) that is consistent with that required by a benchmark efficient firm with similar risk characteristics to the service provider in question. A key feature of the new framework is that the allowed rate of return is effectively determined on a "determination by determination basis".[17] This will enable the regulator to better respond to changing financial market conditions, particularly where volatile market conditions impact on a service provider's ability to attract sufficient capital to finance its expenditure requirements.

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

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

The effectiveness of the Commission's framework for the determination of the allowed rate of return depends, to a significant degree, on how the regulators and the appeal body interpret the new rules. The Commission has taken the opportunity in this final rule determination to explain how the new rules are to be interpreted. Most importantly, the new rules allow the regulator (and the appeal body) to focus on

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

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

whether the overall rate of return meets the allowed rate of return objective, which is intended to be consistent with the NEO, the NGO and the RPP.

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

Return on debt

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

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

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

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

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

4.2.2 Capital expenditure and operating expenditure allowances and related issues

Capex and opex allowances

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

- increases in the rate of return and expenditure allowances have both been significant factors contributing to higher network charges; and some increases in expenditure have been necessary. On the basis of information provided to the Commission it is not possible to tell if constraints on the AER's ability to amend NSPs' expenditure forecasts have caused inefficient increases in expenditure allowances; and
- from a practical perspective the approach in respect of expenditure allowances in Chapter 6A of the NER reflects the approach of regulators in other jurisdictions in Australia and overseas. There are, however, some areas for improvement in the NER, largely to clarify that approach, and to remove any ambiguities.

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

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

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

Annual benchmarking report

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

Other issues

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

- increased consultation on expenditure models – the AER will be required to publish expenditure forecast assessment guidelines and determine how it will be applied at the framework and approach paper stage, which will also apply to TNSPs, see below and section 8.4.3. NSPs will be required to submit complying information with their regulatory proposals. In addition, NSPs are to advise the AER of their approach to preparing expenditure forecasts at the framework and approach stage. This will encourage stakeholders to discuss the model at an earlier stage and before proposals are submitted; and

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

4.2.3 Capex incentives

Sharing schemes, reviews and depreciation

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

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

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

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

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

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

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

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

Related party margins and capitalisation policy changes

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

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

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

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

4.2.4 Regulatory determination process

Steps in the process

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

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

- lengthening the regulatory determination process by four months, for both electricity distribution and transmission. This provides for time for the regulator to prepare and publish an issues paper as well as time for a cross submissions stage later in the process if required;

- the application of an optional framework and approach paper for electricity transmission as well as distribution. Also that documents can be used, where necessary, to settle a number of issues prior to regulatory proposals being submitted. Examples here include information that needs to be provided by the NSP, and the capex incentive package that the AER proposes to apply to the NSP; and

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

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

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

Diverse issues

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

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

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

4.2.5 Transitional arrangements

The Commission has included transitional arrangements in the final rules to enable the regulators to apply the new rules as soon as possible. This will allow the benefits of the new rules to flow through to consumers more quickly.

Transitional arrangements are required due to overlap between the timing of guidelines required under the new rules and that of upcoming regulatory processes, which must follow the guidelines. For example, the final rate of return guidelines may not be complete until November 2013, which is after Ausgrid would otherwise be required to submit its regulatory proposal, in May 2013. Delays to the timing for the regulatory process for the NSPs due to submit in 2013 create congestion for the AER for later regulatory processes, which must then also be delayed.

Transitional arrangements are included in the final rules for both electricity and gas. As well as allowing the new rules to be applied as soon as possible, the transitional arrangements are designed to minimise the resourcing burden on stakeholders and minimise price volatility.

Different transitional arrangements have been designed for different service providers, and in general, the scale of the transitional arrangements reduces as time progresses:

- the current rules have been preserved for SP AusNet (transmission) for three years;
- for most other NSPs whose regulatory control periods are due to commence between 2014 and 2016, the regulatory period remains the same but the AER's decision is delayed by a period of time. An interim determination is made for the first year of the period and a true up is applied at a later stage;
- no transitional arrangements are required for NSPs with regulatory control periods commencing post 2016; and
- two gas service providers in Western Australia will have their next access arrangement reviews delayed to accommodate the development of the rate of return guidelines by the ERA and ActewAGL will have its gas access arrangement review delayed by 12 months to accommodate the 12 month delay to its electricity determination.

5 Approach to general issues

5.1 General approach

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

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

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

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

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

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

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

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

5.2 Drivers for effective network regulation

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

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

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

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

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

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

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

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

5.3 Merits review

While the Commission has been considering these rule change requests the Standing Council on Energy and Resources (SCER) decided to bring forward the review of the

Limited Merits Review (LMR) regime in the NEL and the NGL. In April 2012 a panel was appointed to undertake the review. On 9 October 2012 the panel published its final stage two report.

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

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

The Commission supports the need for accountability of the regulator through some form of merits review. Outcomes for consumers are likely to be improved if the proposed changes in the LMR Panel report to encourage a greater focus on objectives and overall outcomes by the review body are implemented. This final rule determination and the final rule, however, proceed on the basis of the merits review arrangements existing at this time. To the extent that the merits review arrangements change, there may need to be further rule changes as a result. These could include rule changes that arise directly out of such changes, some of which have been suggested by the LMR Panel.[18] They may also include consequential rule changes to align the rules with the changes to the NEL and the NGL regarding issues such as the definition of a reviewable decision.

5.4 Role of consumers

In its rule changes request on electricity, the AER identified what it claimed were specific deficiencies in the way the regulatory process operates. Among other things, it stated that these deficiencies are denying some stakeholders the ability to have input into the regulatory process. On the basis of this and other claims in the rule change requests, the Commission has addressed the regulatory process in a holistic way to best deal with such deficiencies. This is discussed further in chapter 10.

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

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

5.5 The relationship between objectives and factors

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

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

These other matters include factors which the regulator is directed to consider. The rules use language such as "have regard to" and "take into account" to direct the regulator to consider certain factors. Throughout this rule change process there has been discussion over the respective meanings of these phrases. The Commission's approach is that these phrases mean the same thing and nothing is implied by the use

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

of one rather than the other. The Johnson Winter & Slattery advice attached to the Australian Pipeline Industry Association (APIA) submission[19] includes a useful guide to how the phrases should be interpreted. The regulator must actively turn its mind to the factors listed, but it is up to the regulator to determine how the factors should influence its decision. It may, indeed, consider all of them and decide none should influence its decision. It is not intended that the regulator's decision is solely dependent on how it applies any or all of those factors. The intention is that where the rules require the regulator to consider certain factors in conjunction with an overall objective, it should explain its decision including how it has had regard to those factors in making a decision that meets the objective.

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

5.6 Approach to the following chapters

The directions paper and draft rule determination included summaries of responses to consultation in this rule change process. Unless indicated, in this final rule determination, where submissions are discussed, the discussion builds on the previous summary and focuses on new points made by stakeholders.

The draft rules specified the timing of the first guidelines required to be produced by the regulator under the draft rules. On the basis that this is not an ongoing provision of the rules, the timing of the first guidelines is now dealt with as part of the transitional arrangements, and is discussed further in chapters 12 and 13.

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

6 Rate of return framework

Summary

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

Difference between draft rule and final rule

- The final rule closely reflects the draft rule. To the extent submissions have raised concerns about the level of prescription and details in the draft rule, the Commission has considered them in this final rule determination. The final rule strikes an appropriate balance between flexibility and certainty for all stakeholders.
- The final rule includes some minor drafting modifications from the draft

rule to further reinforce the primacy of the overall objective when estimating the rate of return. The rules have also been re-ordered to better reflect the factors that the regulator must have regard to in estimating the return on equity and return on debt components in achieving the allowed rate of return objective.

6.1 Introduction

The return on capital often represents the largest component of the revenue/pricing determinations of service providers. Therefore, the rules on how the rate of return is determined are a key element of the network charges that consumers pay. Under the building block approach to regulating revenues/prices, the return on capital is determined by applying a rate of return to the RAB (electricity) or projected capital base (gas) to determine the return on capital allowance to be included in the revenue requirement in each year of a service provider's regulatory determination or access arrangement.[20]

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

A summary of the current frameworks, including the policy rationale for the frameworks when they were put in place, was provided in the AEMC's directions paper.[21] The directions paper also explained the AER’s rule change request for the rate of return frameworks for electricity and gas transmission and distribution.[22]

Further analysis was provided in the draft rule determination, which also set out the draft rule provisions proposed to give effect to the Commission's conclusions on the AER's rule change request.[23]

This chapter does not include a discussion on issues relating to the estimation of return on debt although it is an integral part of determining the overall rate of return. Such a discussion is included in chapter 7 of this final rule determination.

The remainder of this chapter is structured as follows:

- section 6.2 summarises the Commission's position in the draft rule determination;

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

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

22 Id., pp. 71-73.

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

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

6.2 Directions paper and draft rule determination

6.2.1 Assessment of existing frameworks

Chapter 6A of the NER

The Commission retained its initial view from the directions paper that the rate of return framework under Chapter 6A of the NER is insufficiently flexible to be the best framework for achieving the NEO and RPP in the future.[24] This assessment was based on the view that fixing WACC parameters for long periods produces results that may not reflect current market conditions. Further, it limits the set of information available for estimating parameter values.

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

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

Chapter 6 of the NER

The Commission's conclusion on the rate of return framework under Chapter 6 of the NER was that, while it was more flexible than the Chapter 6A framework, it had shortcomings that meant it was not the best available framework for achieving the NEO, the NGO and the RPP in future.[25]

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

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

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

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

Part 9 of the NGR

In contrast to the electricity frameworks, the Commission concluded that the NGR rate of return framework provides considerable discretion and flexibility, and is intended to be focussed on obtaining a good overall estimate of a rate of return.[26] The Commission considered that the approach of the rate of return framework in the NGR is better aligned with one that could best achieve the NEO, the NGO and the RPP. This is because the NGR specifies an overall objective for the rate of return that directly aligns the estimation process towards achieving the NGO and the RPP.

However, it was noted that the considerable flexibility of this framework did not appear to have been taken advantage of in practice. This may be due to approaches from the more prescriptive electricity regimes influencing the gas regime. Moreover, recent decisions of the Tribunal have interpreted the NGR rate of return framework to apply in such a way as to reduce the range of information that can be used in estimating the rate of return.[27] Such application could lead to the adoption of relatively formulaic approaches to determining the rate of return rather than focussing on the overall estimate.

The Commission observed that under the current NGR rate of return framework, stakeholders would have to participate in every access arrangement decision to influence the regulator's methodology, which may involve relatively high costs.[28] For

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26 Id., pp. 41-43

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

28 In the draft rule determination, it was noted the regulator may decide to have a separate consultation, as the Economic Regulation Authority (ERA) did when it developed its bond yield approach for estimating the return on debt that it proposed in recent decisions. See ERA, *Measuring the Debt Risk Premium – A bond yield approach*, Discussion Paper, 1 December 2010; ERA, *Final decision on WA Gas Networks Pty Ltd proposed revised access arrangement for the Mid-West and South-West Gas Distribution Systems*, 28 February 2011; ERA, *Final decision on proposed revisions to the*

some stakeholders, such as consumer representative groups, this could impose such significant costs that it acts as a barrier to participation. On the other hand, developments in the regulator's methodology through gradual learning in each access arrangement process can be good regulatory practice.

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

Conclusion

The Commission took the view that none of the existing rate of return frameworks are capable of best fulfilling the requirements of the NEO, the NGO and the RPP. The Commission considered that a new rate of return framework is therefore needed.[29]

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

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

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

- is based around estimating a rate of return for a benchmark efficient service provider;
- allows methodologies for parameters to be driven by principles and to reflect current best practice;
- allows flexibility to deal with changing market conditions and the availability of new evidence;
- recognises the inter-relationships between parameter values; and

Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline, 31 October 2011 (as amended on 22 December 2011). The Commission notes that both the access arrangement decisions have amended in accordance with the Tribunal's recent decisions.

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

- creates a framework of accountability for both the regulator and the service provider in determining an appropriate rate of return.[30]

There was broad agreement amongst stakeholders about the appropriateness of these five attributes.[31]

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

- certainty for service providers and their investors as to how the regulator will react to changes in market circumstances and make decisions on an appropriate rate of return; and

- a rate of return framework that allows for more effective consumer participation.

6.2.2 Features of a new common rate of return framework

Estimating a rate of return for benchmark efficient service provider

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

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

Methodologies driven by principles and reflecting current best practice

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

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

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

regulator requires discretion to give appropriate weight to all the evidence and analytical techniques considered.

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

Flexibility to deal with changing market conditions and new evidence

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

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

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

Inter-relationships between parameter values

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

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

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

Accountability for both the regulator and the service providers

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

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

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

Regulatory certainty

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

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

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

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

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

More effective consumer participation

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

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

6.2.3 Nominal post-tax rate of return

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

- the post-tax approach addressed concerns regarding overcompensation for tax in the early years of an asset's life, due to accelerated depreciation provisions for tax purposes which continue to apply to some TNSP assets; and
- convergence in modelling approaches across different energy businesses would improve the ability to compare returns across different regimes, whereas allowing differences in the frameworks applying to TNSPs and DNSPs would not aid in such a convergence.[32]

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

The Commission also gave weight to comments from the AER and the Economic Regulation Authority (ERA). Both submitted that the use of the company tax rate and a conservatively high assumption of the effective tax rate can lead to systematic overcompensation for company tax. The AER also submitted that eliminating the potential for overcompensation requires the precise calculation of an effective tax rate, which is administratively burdensome. Moreover, the calculation of an effective tax rate requires cash flows to be modelled in post-tax terms and then converted into pre-tax equivalents. That is, the regulator would perform a post-tax calculation in either case. As a result, the Commission took the view that a common rate of return framework across the NER and NGR should apply the nominal post-tax approach.

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

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

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

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

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

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

In both the ATCO Gas and DBP cases, the Tribunal rejected the contention of the applicants that giving primary emphasis to rule 87(1) would reflect the NGO and the RPP.[33] Such a conclusion does not reflect the approach of the Commission to determining an appropriate rate of return. The Commission considers that the primary consideration should be whether or not the overall allowed rate of return reflects benchmark efficient financing costs. A focus on the overall estimate of the rate of return is the key objective of the new framework.

The Tribunal suggested in both of these cases that rule 87(1) lacks guidance as to how the objective is to be achieved. Further, it stated that in the interests of regulatory consistency, it is desirable that such guidance be provided, and that rule 87(2) serves that function in describing how the rate of return is to be achieved.[34]

The Tribunal also held that "implicit (or explicit) criticisms of modelling... must be minimised, if not negated, by the requirement that the approach and the model used must be well accepted by those who undertake and use such approaches and models for that purpose".[35] As a result "it is almost inherently contradictory then to say that the approach or the model is not likely to produce a reliable output - assuming that the inputs are appropriate – if that approach and that model are well accepted".[36]

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

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

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

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

36 Ibid.

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

The Tribunal also highlighted its concerns regarding insufficient prescription:

> “The measure of prevailing conditions in the market for funds, and of the risks involved in providing reference services - without prescribing finally how that is done - would be fraught and vulnerable to an evolutionary and possibly idiosyncratic series of regulatory decisions. It would provide less certainty. It would expose the process of selection of rate of return on capital to the risk of prolonged debate about the relevant factor, their empirical measurement and their weightings.[37]”

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

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

6.3 Submissions

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

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

The AER suggests that the overall objective for the allowed rate of return is better achieved by removing from the draft rule the requirements for how the overall rate of

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

return is determined.[38] It suggests that such requirements are better cast as criteria to which the regulator must have regard.

By contrast, the ERA takes the view that not specifying a rule like the existing rule 87(2) in the NGR would lead to a prolonged debate through the process of appeal to the Tribunal.[39]

The ENA submits that the AER should be required to provide sufficient details in the proposed rate of return guidelines to enable stakeholders to derive proxy estimates of the rate of return.[40] This call for greater detail being required in the guidelines has widespread support among submissions from electricity NSPs predominantly but not exclusively.[41]

Gas service providers are generally opposed to any detail being mandated in the proposed rate of return guidelines that could potentially lead to "locking-in" of parameter values. Gas service providers are nonetheless of the view that the draft rule should be further strengthened to require the regulator to use multiple methods, models and evidence in estimating the rate of return.[42]

That there is nothing in the draft rule that prevents the regulators from continuing their reliance on CAPM is a common concern.[43] Some submissions advocate that the regulator should be required to assign weights to the financial models that it intends to use and to explain its rationale for both these weights and the choice of models.[44]

In general, consumer representative groups are satisfied with additional flexibility being provided in the draft rule to the regulator.[45] However, the MEU is particularly concerned that the rule should define a benchmark efficient entity and the basis on which this is to be identified.[46] The EUAA approached the issue of discretion and prescription from a different perspective, submitting that, on the basis of its analysis of past performance of the regulator on the level of rate of return set, it is unlikely that

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

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

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

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

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

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

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

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

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

greater discretion for the AER will significantly impact on the regulator's ability to (potentially) set lower rates of return.[47] This view is shared by other consumer representative groups who commented on the draft rule determination.[48]

6.3.2 Departure from the rate of return guidelines

Electricity NSPs and the ENA suggest that the removal of a persuasive evidence test from the NER rate of return frameworks skews the balance too far toward flexibility from transparent and evidence-based decisions.[49] The electricity service providers are concerned that the Commission's draft rule was increasing the AER's discretion at the same time as evidentiary thresholds were being removed.[50] These submissions called for stronger requirements on a party proposing departure from the rate of return guidelines to justify its reasons and evidence for doing so, based on sound theoretical arguments and verifiable evidence.[51]

By contrast, the APIA and other gas service providers are not particularly in favour of the draft rule requirement for the regulator and the service provider to explain departure from the guidelines as they are concerned that this would result in a tendency for regulators to adhere to guidelines, even in the face of evidence for departure at the time of an access arrangement decision.[52] Arguments were made that though the rate of return guidelines would not be mandatory in their application, they would clearly have presumptive force, leading to concerns that the rate of return guidelines could "inadvertently become a way of entrenching non-reviewable errors".[53]

6.3.3 Development of the rate of return guidelines

Some stakeholders are concerned about the adequacy of the proposed consultation procedures for the periodic review of the rate of return guidelines. For example, some submissions suggested that thirty business days was insufficient time for responding to consultation papers or draft guidelines, and the consultation period should be

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

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

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

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

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

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

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

increased to at least sixty business days.[54] APIA is of the view that, given the introductory nature and the broad range of matters to be considered, the proposed timetable for the first set of rate of return guidelines is too short.[55] Another concern raised by APIA is the absence of a consultation step before the regulator issues its draft guidelines.[56]

Some submissions called for the review period of the guidelines to be lengthened to a four year cycle.[57]

On a related issue, a question was raised as to which rate of return guidelines would apply to a regulatory determination, particularly given the frequency of guideline updates. For example, the submission from SA Power Networks (formerly ETSA Utilities), CitiPower and Powercor claimed that the draft rule was ambiguous as to which rate of return guidelines would apply to a service provider where the guidelines were issued between the draft and final regulatory determinations. These NSPs suggested that this issue could be resolved by amending the draft rule to mandate the application of the guidelines that are in force at the time the framework and approach paper is published.[58] Similarly, it was suggested that it is important that the first guidelines be finalised before any service provider is required to submit under it.[59]

6.3.4 Nominal post-tax basis requirement

Generally, submissions that commented on the draft rule proposal to mandate the rate of return calculations on a nominal post-tax basis were seeking clarification that the AEMC's intention is to preserve the "vanilla WACC" approach currently adopted by the AER.[60]

There were some submissions that did not support the Commission's draft rule proposal. ATCO Gas submits that there should not be a requirement in the rules to use a nominal post-tax approach, claiming that such a requirement would be inconsistent with the flexible approach intended by the Commission.[61] Contrary to the ERA's previous submission to the rule change request, while it supported the specification of

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

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

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

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

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

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

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

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

a post-tax rate of return under the NGR, it stated that there should be no requirement for the approach to be on a nominal basis.[62]

The AER did not express any disagreement with a nominal post-tax approach being made mandatory under the draft rule.[63]

6.3.5 Departure from NSP's proposal on rate of return

The ENA and some NSPs disagree with the Commission's proposal that the allowed rate of return decisions be removed from those decisions that the regulator must make on the basis of what the NSP proposes in its regulatory proposal. That is, they consider that the constraints that apply to the AER's decisions by virtue of clauses 6.12.3(f) under Chapter 6 and 6A.13.2(a) and 6A.14.3(b) under Chapter 6A should apply to the AER's rate of return decisions.[64]

The ENA argue that, while a carve out from clauses 6.12.3(f), 6A.13.2(a) and 6A.14.3(b) might be appropriate for forecast opex and capex to discourage strategic behaviour, it is not necessary for rate of return since it is not affected by information asymmetry.[65] It was submitted that retaining the existing position would improve regulatory certainty and predictability given the increased uncertainty stemming from the increase in flexibility afforded to the regulator under the draft rule.[66]

6.3.6 Other Issues

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

A common suggestion is that the words "commensurate with" should be included as part of the words of the overall allowed rate of return objective. For example, the ENA states that unless there is a deliberate reason for not doing so, the allowed rate of return objective should ideally use terminology consistent with the NEL and the RPP, and not doing so could give rise to unintended consequences.[67]

A related but distinct proposal calls for the reinstatement of "commensurate with the prevailing conditions in the markets for funds" as part of the proposed overarching

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

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

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

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

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

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

allowed rate of return objective.[68] It was also recognised though that a potential adoption of the trailing average approach to debt for some NSPs may have necessitated the excision of this phrase.[69]

In a similar vein, there is concern from gas service providers that the requirement for the return on equity estimation to "take into account" the prevailing conditions in the market for equity funds is not as strong as under the existing rule 87 of the NGR and argued that this needed to be strengthened.[70]

Regarding this same draft rule provision, submissions from the ENA and others suggest that the Commission should clarify that it is not seeking to prevent the consideration of historical or realised returns.[71]

The QTC submits that it is important to clarify that references to "best estimates" relate to those which best promote the NEO, the NGO and the RPP, rather than the most accurate estimate from a purely statistical perspective.[72]

Some stakeholders also query what the intention was regarding the proposed requirement in the draft rule for consistent application of estimates of financial parameters.[73]

The submission from APIA seeks further clarity as to what was intended by "efficient financing costs". APIA suggests that efficient financing costs does not have a readily recognised meaning in the context of economic regulation. Similarly, APIA suggests that "benchmark efficient entity" requires clarification.[74] The MEU is strongly in favour of "efficiency" being defined in the NER and NGR as well as what it considered to be a "benchmark" entity and the basis on which this is to be defined.[75] ATCO Gas expressed the view that benchmarking should reflect the realities of the regulated entity.[76] A different approach is proposed by the Financial Investor Group (FIG), which recommends that "efficient entity" should be defined with reference to a benchmark network business in a competitive market.[77]

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

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

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

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

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

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

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

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

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

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

6.4 Analysis

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

6.4.1 Level of prescription in the rules

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

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

Flexibility and Certainty

The Commission explicitly recognised in the draft rule determination the potential tension between flexibility and certainty in the rate of return framework.[78] Resolving this tension must always be guided by what is most likely to achieve the NEO, the NGO and the RPP.

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

The Commission considers that the NER and the NGR in this context are about providing the regulator with the ability and necessary guidance to regulate the revenues and prices of monopoly networks service providers. In discharging their economic regulatory functions the AER and the ERA are required to consider their decisions in terms of achieving the NEO, the NGO and the RPP. The regulator should be expected to follow good administrative decision-making practice. In this context, such practice requires a full and considered explanation for decisions and adherence to due process, rigour and objectivity required under administrative law principles. That

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

the regulator would strive for the highest quality estimates to best achieve the NEO, the NGO and the RPP can be necessarily expected. If a service provider considers that the regulator has fallen short in this regard, then it can consider appealing the regulator's decision. The Commission is of the view that the NER and the NGR cannot, and should not, be an exercise in rigidly specifying actions for the regulator that are already incumbent upon it.

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

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

Rules

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

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

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

Guidelines

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

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

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

Continued reliance on CAPM

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

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

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

6.4.2 Departure from the guidelines

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

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

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

6.4.3 Development of the guidelines

The Commission recognises that the preparation of the first rate of return guidelines will require extensive consultation. The transitional arrangements for the implementation of the final rules address the timeframes required for the development of the first rate of return guidelines under the NER and the NGR. As further discussed in the transitional rules chapters 12 and 13, a period of up to 12 months has been provided for finalisation of the first rate of return guidelines.

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

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

A preferable way to address the issue is to retain the draft rule approach. This does not preclude the regulator from including in the new guidelines measures that provide certainty to those service providers that would be affected. Further, the draft rule provisions on the guidelines in the NER required the AER to consider transitional issues where there may be changes to regulatory approach in future determinations.[79]

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

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

For the final rule, the Commission has not made any changes from the draft rule on this issue. However, the Commission acknowledges that no equivalent rule of NER

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

clauses 6.2.8(d) and 6A.2.3(d) existed or was proposed in the draft rule for the NGR.[80] The final rule for the NGR rate of return includes the equivalent NER clause for the AER and the ERA to consider transitional issues in making of the rate of return guidelines.

6.4.4 Nominal post-tax issues

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

Prescribing a common approach

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

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

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

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

- more regulatory revenue over the life of assets, as compared to the AER's approach;
- an identical present value of regulatory revenue as the full nominal approach under most circumstances over the life of the assets; and

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

- revenue that is aligned closely with the service providers 'actual' after tax position (as opposed to the regulatory tax position of the benchmark firm).

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

The Commission has sought advice from SFG in relation to this issue.[81] SFG notes the inconclusive nature of the ERA's view on how allowing alternative approaches to the nominal post-tax rate of return better meets the NGO. In SFG's view, there are a number of more compelling reasons to support retention of the draft rule approach. Specifically:

- the ERA submission does not suggest that the AER's PTRM is in any way inconsistent with the NEO or the NGO;
- the ERA submission does compare and contrast the PTRM against its hybrid approach in terms of consistency with the NEO or the NGO;
- retaining the Commissions draft rule mandating a nominal post-tax approach achieves the much supported objective of a common rate of return framework across all sectors; and
- a significant majority of service providers under the NER and the NGR are already regulated by the AER under the PTRM.[82]

The AER has also responded to the ERA's submission on this issue, noting that the revenue differences identified by the ERA are driven by the adoption of specific modelling assumptions rather than whether a nominal rate of return or real rate of return framework is applied.[83] For example, the AER considers that the likely cause of the identified revenue differences are the result of employing different tax input modelling and cash flow timing assumptions between the AER's modelling approach and the ERA's modelling approach.[84]

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

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

82 Id., pp. 7-8.

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

84 Ibid.

It is evident that the differences in views have arisen because of certain modelling assumptions, rather than any fundamental economic requirement to have different approaches being applied to different service providers to determine their efficient revenues/prices. Since the majority of service providers under the NER and the NGR are already subject to the nominal post-tax approach as applied by the AER, it would be more practical to have a common approach already in place extend to all service providers. A common approach will mean that the rate of return can be compared on a consistent basis. Further, as the AER notes, it also avoids the need to direct resources to maintaining different revenue models that deliver the same outcome in terms of the underlying rate of return framework.[85] Consequently, the final rule mandates the use of the nominal post-tax approach to rate of return under the NER and the NGR (see further below on clarification of the form of nominal post-tax approach).

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

It is not the Commission's intention that gas service providers, or indeed consumers, face any unnecessary costs resulting from any transition from a real pre-tax approach. To the extent possible, the Commission would expect the impact on the limited number of gas service providers and their consumers from the change in approach to be neutral. In relation to the specific issue raised by APIA, advice from SFG indicates that there could potentially be a financial loss to a service provider due to expropriation of value from its asset base resulting from the change.[86] However, SFG did not suggest that this issue justifies not applying a common nominal post-tax approach. SFG suggests that this would be a transitional issue under a change of basis for determining the rate of return and could be dealt with by preserving the starting value of the affected gas service provider's capital base.[87]

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

As discussed in section 6.4.3, the final rule provides sufficient flexibility for the regulator to consider potential transitional issues either through the guidelines, or at the time of individual access arrangement reviews. The reason the Commission prefers leaving this issue for the regulator to address is that it is difficult to identify precisely

85 Id., p. 2.

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

87 Ibid.

what the impact will be on those gas service providers at this point in time. The potential effect will depend on the individual circumstances of the affected gas service provider and is better examined at the time of their access arrangement review to enable full consideration of the relevant information. As a result, through this general approach, the regulator could consider the transitory impact in greater detail when developing the rate of return guidelines and make any specific adjustments it considers appropriate tailored to the affected gas service provider at the time of its individual access arrangement decision.

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

Clarification on the intended nominal post-tax approach

In the draft rule, the Commission intended that the AER would continue to use the same definition of WACC as it currently does under its PTRM, as required under the NER. Specifically, the Commission intended that the AER would continue to use the version of the post-tax nominal WACC that has become known as the "vanilla" WACC. To this end, the Commission adopted the same language in the draft rule as that which currently appears in Chapters 6 and 6A of the NER. However, it has become apparent that by removing the WACC formula that is specified in the existing Chapter 6 and 6A and retaining the "nominal post-tax" reference in the rules has the unintended effect of creating ambiguity as to which form of WACC computation would be permissible.

As noted in SFG's advice on this issue:

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

(b) the assumed effect of dividend imputation tax credits are incorporated in the WACC or in the cash flows.[88]"

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

6.4.5 Internal consistency and interrelationships

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

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

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

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

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

88 Id., p. 2.

6.4.6 Benchmark efficiency

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

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

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

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

6.4.7 Departure from NSP's proposal

The Commission has given further consideration to whether or not the rate of return decisions should be subject to the constituent decision constraints of the NER. These constraints relate to the AER's ability to substitute any amount or value on the basis of the NSP's regulatory proposal and amended from that basis only to the extent necessary to enable it to be approved in accordance with the rules.[89]

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

The AER's rate of return decision made at the time of the NSP's regulatory determination would be informed by its decisions in the rate of return guidelines and an assessment of evidence and market conditions at the time of the individual regulatory determination. This would include any reasons for departure from the guidelines provided by the NSP in its regulatory proposal. In order for the AER to make a decision on rate of return that best meets the overall allowed rate of return

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

objective, by necessity the AER must have the flexibility to consider information beyond that which is provided by NSPs in their proposals.

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

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

The Commission has determined that these clauses should not apply for rate of return decisions. In addition, as section 8.4.1of this final rule determination discusses, the Commission has determined that the restrictions these clauses place on the regulator in general are not appropriate, and has removed them from the NER altogether.

6.4.8 Other issues

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

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

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

6.5 Guidance on final rule

This section covers aspects of the final rule on the rate of return framework other than the return on debt, which is discussed in chapter7.

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

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

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

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

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

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

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

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

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

In light of comments from stakeholders, the Commission has reordered the drafting from the draft rule in the final rule to better group the factors that should be considered as part of the determination of the rate of return that meets the overall objective. There is no change as to the intended operation of these clauses. While the final rule gives the regulator discretion in the factors it must have regard to, the Commission considers that the regulator must undertake the rate of return estimation process with rigour and transparency. In this regard, the Commission expects the regulator to use estimating practices that are robust and rely on transparent data sources. It is also expected that the regulator will clearly articulate how it has considered the factors it must have regard to in making its decision on the allowed rate of return that meets the overall objective. The role of factors that the regulator must have regard to or take into account in achieving the objective is more generally discussed in section 5.5

There was some confusion from stakeholders on the draft rule's use of "have regard to and "take into account" in the drafting structure for the new rate of return provisions. The Commission's view on this issue is also discussed in section 5.5.

Estimating return on equity

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

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

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

Rate of return guidelines

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

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

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

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

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

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

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

- incorporate best practice in the application of financial models and market data; and
- be as transparent and open as possible.

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

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

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

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

7 Return on debt

Summary

- Consideration of return on debt methodologies other than the current prevailing market conditions approach has received broad support from stakeholders. Historical trailing average approaches have sufficient merit to be an option for regulators to consider.

- The best methodology for estimating return on debt may not be the same for benchmark efficient service providers with different characteristics. Therefore, the rules should not prescribe a particular methodology for estimating the return on debt component. However, the rules should provide some guidance as to how the best methodology should be determined. The rate of return guidelines will provide a forum to discuss and analyse the best approaches to estimating the return on debt.

- The Commission has not made a rule that would put in place a different approach to estimating the return on debt for privately-owned and state-owned service providers as proposed by the EURCC. The fundamental premise behind this proposal, that state-owned service providers borrow funds in debt capital markets at rates lower than comparable private-owned network service providers, is not correct. It is the treasury corporations of the respective state governments who are able to borrow at rates lower than the private sector due to their ability to issue government guaranteed bonds.

- The most appropriate benchmark to use in the regulatory framework for all service providers, regardless of ownership in general, is the efficient private sector service provider. If state-owned businesses issued their own bonds, without a government guarantee, they would face materially similar borrowing costs to privately-owned service providers. In the absence of competitive neutrality provisions, electricity consumers are unlikely to be better off from defining a separate benchmark for state-owned service. The most appropriate benchmark to use in the regulatory framework for all service providers, regardless of ownership in general, is the efficient private sector service provider.

Difference between draft rule and final rule

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

7.1 Introduction

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

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

Under the current Chapter 6 and 6A of the NER, the return on debt is defined to be the nominal risk free rate plus the debt risk premium (DRP).[90] No such definition exists in the NGR. While the NGR does not mention the DRP, it states that the rate of return for gas service providers is to be commensurate with prevailing conditions in the market for funds and the risk involved in providing reference services.[91]

A more detailed discussion on the application of the current rules on return on debt, including the risk free rate and the DRP, was provided in the directions paper.[92] It also explained the rule change requests from the AER and the EURCC on return on debt that have been consolidated by the Commission.[93]

The remainder of this chapter is structured as follows:

- Section 7.2 summarises the Commission's position in the directions paper and draft rule determination;
- Section 7.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 7.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and

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

91 See NGR rule 87(1).

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

93 Id., pp. 98-101.

• Section 7.5 provides guidance on the final rule.

7.2 Directions paper and draft rule determination

7.2.1 Options to use different methodologies

In the lead up to the draft rule determination, the AEMC undertook extensive consultation with stakeholders on the merits of allowing the rate of return to consider a historical trailing average approach to estimating the return on debt. The Commission noted the widespread, though not unanimous, support for consideration of a historical averaging approach.[94] A case was made, for example by the QTC, New South Wales Treasury Corporation (NSW T-Corp) and Ausgrid, that the current regulatory position of calculating interest rates on debt over a 20 to 40 day period encourages risk management behaviour in service providers that, in general, would not likely occur in the absence of such regulation. They argued that it also comparatively disadvantages large service providers whose ability to hedge large volumes of interest rate risk over such a short period is severely limited by the size and liquidity of the relevant markets.[95] The Commission also noted that submissions against the introduction of an averaging approach were based on arguments that such an approach would not properly reflect service providers' efficient financing and risk management strategies.[96]

To inform its analysis, the Commission engaged SFG to advise on the potential impacts of adopting a historical trailing average approach to estimating the return on debt. SFG was asked to consider the impact on the risks faced by the shareholders of the service providers and the impact on the incentives for service providers to undertake efficient capex. It is in these two ways that the introduction of a trailing average approach to estimating the return on debt could lead to more efficient outcomes to the benefit of consumers.[97]

In its report, SFG highlighted that for a given definition of the return on debt for an efficient benchmark service provider (in particular, the assumed credit rating and term to maturity) the average cost of debt will be the same over the long run. This is regardless of whether the return on debt estimate is based on the prevailing debt cost spot rate or an average of that spot rate.[98] Changing to an averaging approach will not,

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

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

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

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

98 Id., p. 4.

in itself, systematically reduce or increase the allowed return on debt in the long run. SFG observed that averaging approaches will, by definition, result in smoother estimates of the return on debt over time.[99]

SFG was also requested to provide analysis of a number of different approaches to implementing a trailing average approach to estimating the return on debt that covered the range of approaches proposed during the rule change process. The options analysed by SFG took account of the proposed approaches of EURCC,[100] the QTC[101] and SA Power Networks (previously ETSA Utilities), CitiPower and Powercor.[102] SFG compared these approaches to the current approach, defined as an estimate of the return on debt for a service provider estimated at the time of each regulatory determination or access arrangement over a 20 to 40 day rate setting period. SFG's analysis isolated the impact of introducing different forms of a historical trailing average approach from the impact of different benchmark specifications for estimating the return on debt.

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

In summary, SFG concluded that:

- The introduction of historical trailing average approaches for estimating the return on debt has the potential to reduce the risks faced by equity holders of some service providers. This is because a historical trailing average approach can allow a service provider to more closely match its debt servicing costs to the regulatory allowance for the return on debt.

- Currently service providers have varying abilities to match their debt servicing costs to the regulatory allowance for the return on debt. Some of the smaller privately-owned service providers appear able to hedge their interest rate very well, but larger state-owned service providers such as those in NSW and Queensland appear unable to enter into these hedges because the relevant financial markets are not sufficiently deep to meet their requirements. The reduction in risks for equity holders of moving to an historical trailing average approach is greater for those least able to currently match their debt servicing costs to the regulatory allowance. For those able to achieve a good match

99 Id., p. 5.

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

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

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

currently the introduction of a trailing average approach may slightly increase the risks for equity holders.

- A historical trailing average approach to estimating the return on debt can lead to significant differences between the regulatory allowance for return on debt and the cost of debt in the market for funds at any point in time. Such a difference could impact the incentives for service providers to invest efficiently in capex. For example, if the cost of debt in the market for funds is higher than the regulatory allowance then the service provider may not invest as much as would be efficient. SFG noted that the QTC's proposal for a historical trailing average return on debt provided one way to address this risk.

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

In its draft rule determination, the Commission noted that the apparent diversity of stakeholder views was consistent with modelling analysis from SFG. It suggests that, for service providers with significant refinancing risks, the cash flow volatility of equity returns can be substantially reduced by moving to a trailing average approach. However, for others, the current prevailing rate approach is slightly better at minimising the volatility of returns.[103]

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

The draft rule did not set the return on debt by reference to any particular base rate and DRP. The Commission took this view to allow the regulator sufficient flexibility to determine historical averages of either the entire return on debt or just the DRP component. Furthermore, the Commission's intention was to ensure that there is the flexibility to set a DRP against a base rate other than the Commonwealth government

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

bond rates (eg bank bill swap rates), if that was considered appropriate by the regulator. The Commission considered this flexibility to be important to allow the methodology used to estimate the return on debt to reflect the borrowing and risk management practices of an efficiently run service provider.

The Commission also noted that regulators in some overseas jurisdictions have adopted similar approaches to the type of historical trailing average approaches that were discussed during this rule change process. For example, Ofgem, as part of its transmission and gas distribution price controls to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model, has applied an index to the return on debt allowance. Ofgem has noted that indexation, in and of itself, does not preclude regulated businesses from entering into any particular hedging strategy. Also, indexation ensures that efficiently financed debt is funded, even if the market cost of debt is above the return on debt allowance at the time of debt issuance.[104]

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

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

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

7.2.2 Specification of benchmark characteristics

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

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

and that process will provide an opportunity for all stakeholders to submit their views and discuss any differences of view.

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

7.2.3 Return on debt for state-owned service providers

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

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

Under the CPA, competitive neutrality principles must be applied by governments, where appropriate, to all significant state-owned businesses, including at the local government level.[105] The CPA also imposes a set of obligations on all governments in relation to taxation, debt and regulatory neutrality, full cost attribution and setting prices to earn a commercial rate of return.

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

- full Commonwealth, State and Territory taxes or tax equivalent payments;[106]
- commercial rate of return requirements and an obligation to pay dividends;
- requirements that prices reflect the full cost of providing network services;
- debt guarantee charges to offset cost advantages of implied government borrowing guarantees; and

105 Competition Principles Agreement subclause 3.(1).

- regulations applying to private sector competitors.

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

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

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

- it will potentially create artificial geographical market distortions in generation and network capacities across the NEM because of the pricing signals that would be created due to network ownership;

- it risks distorting the incentives of efficient capital financing structures of state-owned network service providers compared to privately-owned service providers. In such circumstances, there is likely to be a material impact on consumers as ownership changes are considered; and

- the separate roles of shareholders and taxing authority where governments are also the owners of the service providers.

7.3 Submissions

7.3.1 Options to use different methodologies

The Commission's draft rule determination to allow different methodologies to estimate the return on debt under a flexible rate of return framework received widespread support. However, submissions from service providers expressed concerns that, under the draft rule, a new methodology could potentially be imposed on them

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

by the regulator that could be unsuitable to their financing practices. They argue that the choice of methodology should not be at the sole discretion of the regulator.[107] The main arguments they make in relation to this are that:

- some service providers' debt portfolios may make a trailing average approach untenable;[108]
- a one-size-fits-all approach is inappropriate and the rules need to be flexible enough to accommodate different approaches across different service providers;[109] and
- service providers are better placed to judge optimal debt management strategies.[110]

The MEU is concerned that allowing service providers to seek a different return on debt estimation methodology, rather than having it imposed unilaterally by the regulator, would allow for "gaming" by the service providers.[111]

Another key issue of concern for stakeholders is the criteria or factors proposed by the Commission for assessing the appropriate approach for estimating the return on debt. The QTC submits that it agrees broadly with three of the criteria but one of them is unnecessary.[112] APIA suggests that the factors are duplicative of the requirements of the NGO and the RPP and create either ambiguity or "double legislation" and are therefore redundant and should be removed.[113] The ENA submits that the criteria do not provide adequate guidance to the regulator and some are unlikely to be consistent with the NEO, the NGO and the RPP.[114]

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

- are ambiguous and the AEMC's stated intention has not translated to the rules;

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

108 See, for example, DBP, Draft Rule Determination submission, 9 October 2012, pp. 4-5; The Financial Investor Group, Draft Rule Determination submission, 4 October 2012, pp. 20-21.

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

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

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

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

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

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

- appear to be conflicting and do not provide any guidance as to how conflicts between them are to be resolved;
- does not include any measures to ensure service providers are afforded a reasonable opportunity to recover benchmark debt costs over the long term; and
- do not require the regulator to take into account legitimate business interests around transition and changes in methodology after transition.[115]

The ENA suggests that clearer rules-based guidance is essential.[116] There is also a suggestion from some service providers that a higher level of prescription be included in the rules. For example, this should extend to setting out the form of debt (BBB+ Australian corporate bonds) and should include more directly relevant criteria against which to assess the proposed methodology.[117]

In a similar vein, there are also calls from some stakeholders that the rules should set out some details (eg benchmark gearing, credit rating, maturity) that the regulator should have to address in the rate of return guidelines.[118] The QTC suggests that given the relationship between efficient debt strategies and efficient debt costs, the guidelines should describe the main characteristics of efficient debt funding and risk management strategies for infrastructure service providers.[119] These characteristics would then need to be taken into account by the regulator when assessing a proposal and for determining the benchmark.[120]

7.3.2 Specification of benchmark characteristics

The appropriate benchmark

The MEU suggests that there should be more emphasis on the concept of best practice to ensure that debt is secured in the most efficient way.[121] The MEU also takes the view that the term of the debt used as the benchmark should be in line with the length of the regulatory period.[122] It has no fixed view on the averaging period used for interest rates, other than it needing to be consistent and stable.[123]

115 Id., pp. 22-23.

116 Id., p. 23.

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

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

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

120 Ibid.

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

122 Id., pp. 17-18.

123 Id., p. 19.

The main concern of the ERA is ensuring that the proposed rule changes do not preclude its bond yield approach.[124] It considered that it does not.[125]

The QTC is concerned that broad regulator discretion could lead to debt benchmark characteristics that constrained the ability of service providers to adopt efficient debt financing and risk management strategies.[126] It suggests that the rules should require the regulator to demonstrate that their benchmark would not do this.[127]

Gas service providers stress the individually distinct nature of gas pipelines, which implies the need for more than a one-size-fits-all approach to any benchmark.[128] ATCO Gas, for example, argues that:

- the benchmarking process should not be used to ignore or "assume away" risks;
- the benchmarking process should not treat unlike businesses as though they are alike;
- in general, credit ratings should not be benchmarked; and
- the benchmarking process should not be used to ignore market realities.[129]

The joint submission from SA Power Networks, CitiPower and Powercor calls for the return on debt benchmark to be based on BBB+ 10-year Australian corporate bonds.[130] These NSPs argue that this has been the consistent definition in the past and does not require a change.[131] They reiterate their suggestion that, in estimating the return, the regulator should have regard to a wide range of data, including BBB+ bonds with maturities less than 10 years and bonds with different credit ratings.[132]

The ENA and some service providers suggest that the draft rules did not sufficiently distinguish between benchmark specification and estimation.[133]

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

125 Ibid.

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

127 Ibid.

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

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

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

131 Ibid.

132 Ibid.

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

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

The MEU submits that the regulator should be required to examine the actual historical practice of service providers to assist in identifying the most efficient structure for debt financing.[134]

The FIG is concerned that a number of provisions can be misinterpreted as suggesting that the cost of debt allowance should be adjusted to reflect the service provider's actual cost of debt. It considers that the rules should make it much clearer that the requirement is to set a benchmark cost of debt for an efficient firm.[135]

7.3.3 Return on debt for state-owned service providers

The EUAA disagree with the arguments made by the Commission for why return on debt for state-owned service providers should not be different from that for privately-owned service providers.[136] It argues that:

- the absence of competitive neutrality fees could not be expected to have any meaningful impact on allocative efficiency;[137]
- based on EURCC calculations, it was difficult to argue that taxpayers would be subsidising electricity users in the absence of competitive neutrality fees;[138]
- income taxes should be counted as part of the return on equity for government-owned service providers;[139]
- there is no meaningful level of competition between government-owned service providers and therefore the rationale for the application of the Competition Principles Agreement to these service providers is not valid; and[140]
- just as the AEMC proposes to guard against transfer pricing arrangements between related parties it should do the same for competitive neutrality fees as they are substantially the same thing.[141]

Submissions from some other consumer and energy user representative groups either endorse the arguments of the EUAA or make substantially similar arguments.[142]

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

135 The Financial Investor Group, Draft Rule Determination submission, 4 October 2012, p. 20.

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

137 Id., pp. 9-10.

138 Id., p. 10.

139 Id. pp. 10-11.

140 Id., p.11.

141 Ibid.

7.4 Analysis

7.4.1 Options to use different methodologies

Proposal for return on debt methodology by the service provider

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

Factors to consider as part of assessing methodologies

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

The factors reflect a number of key issues raised by SFG in its analysis of different methodologies for estimating the return on debt, and other stakeholders during the rule change process.[143] These issues can be summarised as follows:

- efficient benchmarking service providers may have different efficient debt management strategies;
- the effect on the cost of equity of different methodologies for estimating the return on debt;
- the effect on incentives for efficient capex during the regulatory period of the methodology used to estimate the return on debt; and
- consideration of whether transition arrangements are required if there is a change in the methodology used to estimate the return on debt.[144]

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

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

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

144 Id., p. 7.

practices tend to differ according to the size of the business, the asset base of the business, and the ownership structure of the business.[145]

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

The second factor requires the regulator (and service providers when making their proposals) to have regard to any potential benefit to consumers that could flow from reduced financing risks that may result from different return on debt methodologies. The intention is to require consideration of the potential impact on the return on equity that may result from a return on debt methodology that reduces the overall volatility of cash flows to equity holders. As modelling results provided by SFG show, in certain cases the cash flow volatility to equity holders can be reduced by better matching the debt component of the regulated return with borrowing costs.[146]

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

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

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

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

145 Id., p. 21

146 Ibid.

7.4.2 Specification of benchmark characteristics

The appropriate benchmark

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

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

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

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

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

7.4.3 Return on debt for state-owned service providers

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

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

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

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

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

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

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

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

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

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

Allocative inefficiency

The Commission rejects the assertion that its arguments in the draft rule determination with respect to the absence of competitive neutrality fees are internally inconsistent.[147] It is clear from the wording of the draft determination cited by the EUAA that the Commission is presenting two possible outcomes that could arise in response to a removal of the fees, where the actual result is dependent on the response of the governments.[148] Specifically, absent any response from the government, the service provider could be expected to overspend. Whereas under the assumption that governments would alter their behaviour, stated as "arguably more likely", the service provider could then be expected to underspend.[149]

The Commission also disagrees with the EUAA's suggestion that it "erred because it has ignored the reality that service providers (that the governments own) are accountable to their government owners and so the cost of debt that they might see (after debt fees payable to their State Treasuries) is not relevant in their investment decision-making".[150] The EUAA conflates the role of shareholder management with the role of government. For privately-owned service providers the question is not as to what rate the shareholder can personally borrow at, but rather, as to what is the required rate of return given the risk of the businesses. There is no reason why tax-payers should not receive the same treatment. Just as it would be inappropriate for consumers to appropriate efficient returns made by private investors in risky assets, it

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

148 Ibid.

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

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

is similarly inappropriate for consumers to appropriate efficient returns due to taxpayers.

Taxpayers subsidising users

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

Taxes counted as return on equity

The Commission retains its position outlined in the draft rule determination that taxes are not a part of the return on equity. It further notes that the EUAA submission argues that distinguishing between tax receipts and return on equity is "to argue that administrative form should triumph over economic substance", at the same time as arguing that taxpayers should receive less return on risky assets than private investors.[151]

Competition or monopoly

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

Regulatory authority

The Commission notes that the EUAA considers that there is a "double standard" at work predicated on its conflation of transfer pricing arrangements between related parties and the competitive neutrality fees charged by governments.[152] The Commission does not accept the comparison as valid. Further, even if were to accept the argument, this would not mean that the Commission would consider it appropriate or feasible to attempt to circumvent the CPA.

7.5 Guidance on final rule

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

This section should be read in conjunction with the section in the previous chapter that discussed the final rule for the overall rate of return framework, including how the final rule is to be interpreted. It is particularly important to note that the final rule places a requirement on the regulator to determine a rate of return that meets the

151 Id., p. 11.

152 Ibid.

overall allowed rate of return objective. This requirement can only be fully satisfied if the regulator considers its overall estimate against that objective. The Commission does not consider that the regulator could be satisfied it had met that overall objective if it made estimates about components or parameters that form part of the rate of return estimate in isolation and without considering the overall estimate against the overall objective. Therefore, those aspects of the final rule that relate to the return on debt estimate should be seen as part of the analysis to inform the estimate of an overall rate of return.

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

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

The Commission intends the regulator (and the service provider in its regulatory proposal or access arrangement proposal) to have the discretion to propose an approach that it considers best meets the overall allowed rate of return objective. This discretion for the regulator includes the detail of any approach, such as the period over which a prevailing cost of debt is observed, the length of any historical averaging period, and the form of measurement of the observed financing costs. In all cases the regulator's judgement is to be exercised in such a way as to be consistent with the overall allowed rate of return objective.

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

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

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

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

8 Capex and opex allowances and factors

Summary

- The Commission has analysed evidence provided to it of the drivers of higher prices, which indicate that both the rate of return and expenditure allowances have been significant factors. However, it is not possible to discern if they have been inefficient, or if there is a problem with the NER.

- The approach to expenditure allowances was set by the AEMC in Chapter 6A in 2006. It includes that the NSP's forecast should be the starting point for the AER's analysis, but the AER is free to use a range of analytical techniques and should consider all material and submissions before it.

- Analysis confirms that the practices of the AER conform to good regulatory practice when compared with other regulators in Australia and overseas, and the Commission's view is that the NER reflects these practices.

- In general, the existing provisions of the NER provide the AER with appropriate discretion to set capex and opex allowances at an efficient level, assuming it has adequate information and uses appropriate analytical techniques.

- However, there are some areas for improvement to clarify the approach and remove ambiguities, specifically in relation to the AER's discretion and benchmarking.

- Benchmarking can play an important role in assessing the efficiency of a NSP’s capex and opex forecasts. Any use of benchmarking should take into account differences in the operating environments of the different NSPs. The AER should be required to undertake annual benchmarking of NSPs.

- It is appropriate that the approach for assessing expenditure forecasts be set out in guidelines. NSPs will be required to submit complying information with their regulatory proposal. Early engagement on these models with the NSP's is beneficial and should be included as part of the framework and approach paper.

Difference between draft rule and final rule

- In the final rule, the AER's discretion has been further clarified by the removal of general restrictions on the AER's discretion, consistent with the Commission's overall approach in this rule change.

- The obligation on a NSP to submit forecast expenditure methodologies as required by the AER has been adjusted. Instead the NSP may provide assessment information required by the AER separate to its regulatory proposal.

8.1 Introduction

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

The NER provide matters for the AER to take into account in approving this important aspect of a NSP's total revenue requirement. The AER claims that the NER have constrained its ability to interrogate and amend expenditure proposals, resulting in capex and opex allowances which are higher than they should be.[153] While there are legitimate reasons for increases in network charges, it states that these constraints are also driving up network charges.[154] The AER proposed to be able to independently develop forecasts to use in scrutinising and amending NSPs' proposals.

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

The remainder of this chapter is structured as follows:

- Section 8.2 summarises the Commission's position in the directions paper and draft rule determination;
- Section 8.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 8.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- Section 8.5 provides guidance on the final rule.

8.2 Directions paper and draft rule determination

The draft rule determination proposed amendments in three areas:

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

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

154 Id., p. 6.

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

8.2.1 Clarifying the discretion of the regulator

Background analysis

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

The ENA included a critique of Bruce Mountain's report in its submission to the directions paper stating that the analysis is too simplistic to be robust.[155] In the draft rule determination, the Commission accepted that it may be possible to undertake a more sophisticated analysis, however, no analysis has been provided which would challenge its conclusion that the average privately-owned DNSP is more efficient than the average state-owned DNSP.

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

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

The Brattle report considered whether the overall approach to expenditure allowances in Chapter 6A of the NER, and the AER's practices in applying Chapter 6A, conform to good regulatory practice. In addition to the AER, Brattle considered the regulatory

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

approaches in Great Britain, New Zealand, New South Wales, Western Australia, Ontario and Rhode Island.[156]

Brattle did not identify any fundamental differences between the approach of the AER and the practices of regulators in the other jurisdictions. It noted that while the level of prescription in the rules differs among jurisdictions, the regulators operating under 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.[157] Rules may affect the weight put on the results of different analysis, but Brattle is not able to determine this conclusively.[158] On the basis of Brattle's conclusion, the Commission took the view that the approach to expenditure allowances in Chapter 6A, which generally reflects the AER's practices, remains fairly consistent with good practice as reflected in the practices of the other regulators examined by Brattle.

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

Brattle also highlighted the importance of good data for setting expenditure allowances at the right level. This includes annual data collection outside the determination process, and regular interaction with NSPs to ensure that the data collection process is operating effectively.[159]

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

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

156 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.

157 Id., paragraphs 13, 30 and 31.

158 Id., paragraph 33.

159 Id., paragraph 44.

some changes for clarification reasons should be made so that Chapters 6 and 6A of the NER better reflect this approach.

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

Proposed amendments

The Commission confirmed that the NER is drafted appropriately in many areas. With the exception of benchmarking, the capex and opex criteria remain valid. For example, the obligation to accept a reasonable proposal should reflect the AER's current practice. There is no reference to a reasonable range, which is appropriate.[160] 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.

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.[161] In jurisdictions where this did not occur, the regulator tended to be reviewing a large number of smaller businesses, such as in New Zealand. Of much more import is whether the AER has the necessary tools to scrutinise the NSP's proposal.

In the draft rule determination, the view was taken that the extent of the constraint imposed on the AER by clause 6.12.3(f) is unclear. This could be read as merely requiring the AER to treat the NSP's proposal as an input into its determination of a capex or opex allowance, or as preventing an AER substitute from moving away from a NSP's proposal beyond what is necessary to result in a reasonable allowance. NSPs stated that clause 6.12.3(f) is clear, but there have been few strong arguments about the benefits of this clause - and why it should be retained - in respect of capex and opex.[162] On the other hand, the AER has interpreted these provisions as imposing a much greater constraint on it.[163] Brattle also observed problems with this provision:

> "... it may be that neither 'adjusted only to the extent necessary' nor 'based on the NSP proposal' are helpful guides to the exercise of the regulator's judgment, in particular, if this were interpreted to rule out 'top down' adjustments.[164]"

Therefore, the Commission determined it should be made clear that clause 6.12.3(f) does not apply to capex and opex allowances. The guidance provided by this clause, such as requiring the AER to take into account the NSP's proposal, would be achieved by other provisions anyway, and this clause represents a difference between Chapters

160 Id, paragraph 42.

161 Id., paragraph 14.

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

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

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

6 and 6A for which there is no substantive benefit. The AER should not be limited to assessing a proposal on the basis of a "bottom up", engineering-based approach, and the AER should be free to determine a substitute amount on the basis of the information it has.

The AER proposed that the criterion relating to demand forecasts and cost inputs[165] was less important than the first two criteria and should be moved to the capex and opex factors. The view was taken in the draft rule determination that it would position demand forecasts and cost inputs as objectives rather than key elements of expenditure allowances that are relevant in a range of ways. The Commission therefore remained of the view that this criterion should remain where it is.

It was also determined that any impediments as to the use of benchmarking in the AER's analysis should be removed. The Commission views benchmarking as an important exercise in assessing the efficiency of a NSP and informing the determination of the appropriate capex or opex allowance. As a result, the Commission decided that the reference to "circumstances of the relevant NSP" should be removed from the capex and opex criteria. This was on the basis that there appears to be little doubt about how the AER should undertake a benchmarking exercise, including the circumstances that should be taken into account, and the reference to individual circumstances is likely to constrain the AER in an inappropriate way.

Other issues

The Commission shared the view expressed by Brattle that there could be greater consistency between Chapters 6 and 6A.[166] While recognising that these Chapters were developed by different organisations at different times, there should be no reason for any differences unless these are based on a fundamental difference between the characteristics of transmission and distribution networks or their owners. Differences in the NER not based on this may lead to ambiguity and a loss of clarity. In time, it may be possible for Chapters 6 and 6A to be merged into one. At present, changes are limited to those within the scope of the rule change process.

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

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

166 Id., paragraphs 21, 35 and 41.

In the directions paper, the Commission noted the concern raised by the AER that the use of the word "maintain" in the capex and opex objectives may mean the AER is constrained in its ability to adjust expenditure allowances in the event that jurisdictional standards, for example, were to decrease or be relaxed.[167] It was decided in the draft rule determination that a change to these objectives would be outside the scope of this rule change. The Commission has since received a rule change request from the SCER which it will be considering in due course.[168]

8.2.2 Annual benchmarking reports and engagement on expenditure models

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

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

Each of these is discussed below.

Annual benchmarking reports

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

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

In order to undertake an annual benchmarking exercise, the AER should use the best information available to it. Brattle underlined the importance of annual data collection outside of the regulatory determination process, and noted the effort other regulators

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

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

have put into doing this.[169] It was noted that the AER does not undertake information gathering and benchmarking to the same extent as many other regulators but that may be limited by legal constraints on its information gathering powers.

Under section 28V of the NEL, the AER has the power to prepare network service provider performance reports. The annual benchmarking reports proposed in the draft rule are a subset of the reports the AER may publish under section 28V. However, there are limitations on using regulatory information instruments solely for the purposes of preparing network service provider performance reports: section 28F(3)(d) of the NEL. Changes to the NEL are outside the AEMC's power, however the SCER may wish to address this further. Changes to the NER may also provide the AER with greater powers in this respect. It was noted that the AEMC proposed to the SCER as part of its work on total factor productivity possible rule changes which would require NSPs to provide benchmarking information to the AER.[170]

Engagement on the expenditure model

The AER proposed in its submission on the directions paper a new solution for dealing with the problem raised in its rule change proposal of determining whether a NSP's capex or opex proposal is efficient.[171] This solution would require consultation 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 it, including any departures it has made from the model. This would enable more time for the AER to understand NSPs' forecast models, as well as be able to compare NSPs on a similar basis.

The Commission noted that the AER currently has difficulty in requiring a NSP to use a particular model to prepare its expenditure forecasts. Even if the AER has a preferred approach, the NSP need not use it. This means that the AER must spend time after the NSP's regulatory proposal is submitted to understand the NSP's model and engage with the NSP in respect of it.[172]

The Commission considered the best approach was to mandate the expenditure models to be used to prepare capex and opex forecasts. The view was taken that there were not any disadvantages in an approach which encouraged stakeholders to engage on the expenditure methodologies at an earlier stage. If the AER and stakeholders do not engage on the expenditure methodologies until after the regulatory proposal is submitted it will take up time during the evaluation stage. More critically, if the AER prefers a different methodology it may take the NSP some time to collect relevant information, putting pressure on the rest of the process. Instead, any expenditure methodology or methodologies preferred by the AER for a particular NSP should be included in the framework and approach paper. Importantly, for flexibility, it was

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169 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.

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

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

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

decided that there should be no restriction on a NSP also including expenditure forecasts generated using other methodologies in its regulatory proposal.

8.2.3 Capex and opex factors

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

Process-related changes

The Commission maintained its position in the draft rule determination from the directions paper to move the process-related changes from the capex/opex factors to the "procedural" provisions further back in Chapters 6 and 6A.[173] These provisions have a different character from the other factors in that they deal with the materials presented to, or obtained by, the AER in the course of the regulatory process, as opposed to facts or data. As such, they sit better with the other procedural provisions, such as clause 6.11.1.

The ENA raised a concern at law that the AER's proposed shift from "have regard to" wording to "consider" wording in respect of two of these factors will affect the overall decision-making process.[174] To accommodate this, the draft rule adopted the "have regard to" wording for all three factors.

The Commission further considered the views it presented in the directions paper regarding the requirement on the AER to consider analysis it has published.[175] It acknowledged the challenges in using merits review to test analysis published with a final regulatory determination, and notes that under section 16(1)(b) of the NEL the AER is required to inform NSPs of material issues under consideration, as raised in the ENA's submission.[176] However, the Commission maintained the position that because of the fixed time the AER has to reach a final regulatory determination there could be times when it is too difficult for the AER to consult on analysis prior to it. To balance the time constraints against the need for scrutiny of new material, the draft rule required the AER to use its best endeavours to publish analysis on which it proposes to rely, or which it proposes to refer to, prior to the making of the final regulatory determination. Further, in the event of any inconsistency between the NER and NEL, the NEL has priority over related provisions of the NER.

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

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

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

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

Non process-related changes

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

Various other changes to the capex and opex factors were also proposed. One factor relates to the service target performance incentive scheme (STPIS) (see for example clause 6.5.6(e)(8)). The original intent behind this factor is that expenditure allowances with respect to labour costs should be sufficient to allow the NSP to respond to the incentives as part of the STPIS. The AER has suggested this factor could be broadened.[177] The Commission agreed with this and removed the reference to labour costs and broadened the scope of the incentive schemes covered. In addition, consequential amendments were proposed to the capex and opex factors in Chapter 6 to recognise the addition of the contingent projects regime.

It was also proposed that the factor relating to benchmarking[178] be expanded to refer to the annual benchmarking reports.

Finally, a factor was added that requires the AER to have regard to the extent to which NSPs have considered what consumers seek. NSPs should be engaging with consumers in preparing their regulatory proposals and should factor in the needs and concerns of consumers in determining, for example, their capex programs. What consumers want and are prepared to pay for, whether in terms of reliability or some other element, will assist in showing what is efficient. The more confident the AER can be that consumers' concerns have been taken into account, the more likely the AER could be satisfied that a proposal reflects efficient costs. A similar approach is taken in Great Britain by Ofwat in respect of water regulation.[179]

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

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

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

8.3 Submissions

Submissions from consumer representative and large user groups are supportive of the changes proposed in the draft rule determination.[180] The AER is also strongly supportive of the changes. It states that the draft rules are a clear improvement by allowing it greater scope to reject excessive cost forecasts. However, it has raised concern over the remaining restrictions in clause 6.12.3(f) as well equivalent clauses in Chapter 6A (discussed below).[181] Independent Pricing and Regulatory Tribunal (IPART), the Victorian Department of Primary Industries (Victorian DPI) and retailers are also supportive of the changes.[182]

UE and MG support the changes to clarify the NER as well as benchmarking. However, like many of the NSPs, they do not support the changes in relation to an expenditure forecast methodology, which is also reflected in the ENA's submission.[183] The ENA also has concerns in relation to benchmarking and the amendments to clause 6.12.3(f).[184] Submissions on all three of these specific issues are discussed below.

8.3.1 Clarifying the discretion of the regulator

The AER supports the reasons for the amendments to clause 6.12.3(f) but states that it still restricts the AER from making overall decisions. It proposes for the clause to be deleted, as there have been no strong arguments to support the retention of the remaining restrictions. It states that without the clause it is still required under administrative law and other clauses in the NER to take into account a NSP's proposal and all relevant information.[185]

SA Power Networks, CitiPower and Powercor submit that the clause should remain unchanged. It states that the clause is consistent with the recognition that the NSP's proposal is the most detailed and relevant evidence.[186] The ENA disagrees with the

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

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

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

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

184 ENA, Draft Rule Determination submission, 4 October 2012, pp. 19-21, 33-36.

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

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

carve out of rate of return from this clause.[187] This has been discussed in section 6.4.7 . The ESAA has also raised that by providing more discretion to the AER increases the risk that overall revenue is inadequate and the AER needs to carefully consider how it minimises this risk.[188]

8.3.2 Benchmarking

UE and MG disagree with the draft amendment to remove the "individual circumstances" phrase. They state that an assessment of prudent and efficient expenditure requires consideration of the particular circumstances and that without it there is a signal that a NSP's circumstances are not relevant.[189] Likewise, SA Power Networks, CitiPower and Powercor disagree with the removal of the phrase, since the AER has been shown not to consider individual circumstances in cases before the Tribunal.[190] The ENA also disagrees with its removal stating that the phrase does not constrain benchmarking and that recognition of individual circumstances are a fundamental element for an assessment of forecasts.[191] Grid Australia also disagrees with the removal of the phrase.[192]

Grid Australia is concerned about the role of benchmarking and refers to the findings of the Total Factor Productivity Review (a form of benchmark regulation) which found that it is not appropriate to be applied to transmission.[193] Ergon Energy states that consideration should also be given to the costs of collection of additional information and that differences in networks mean it may not be possible to take into account all relevant factors. In that case, the AER should have discretion not to publish an annual report. If required to publish one, it should not be directed to have regard to the last one as there will be a lag with the data and as a result publication of such a report is likely to mislead less informed market participants.[194] SA Power Networks, CitiPower and Powercor have no objection to the preparation of benchmarking reports but consider further guidance useful, such as the relevant factors to consider.[195]

The AER is supportive of the changes to benchmarking, as is Origin Energy.[196]

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

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

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

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

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

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

193 Ibid.

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

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

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

8.3.3 Expenditure forecast methodology

SP AusNet states that the expenditure forecast methodology conflicts with the NSP's responsibility for preparing and submitting expenditure forecasts in its regulatory proposal. Furthermore, it states that an additional methodological approach in addition to the one preferred by the NSP will result in duplication.[197] Jemena also does not support a standard expenditure forecast methodology. It states that it is inconsistent with current sign-off requirements and will duplicate work where a NSP still needs to provide its own best forecast and the AER must evaluate both.[198] The ENA provides similar reasons in its submission, it states that it would be more appropriate to require NSPs to provide an informal briefing to the AER on their approaches at the framework and approach stage. The ENA provides alternative rule amendments consistent with its recommendations.[199]

On the contrary, SA Power Networks, CitiPower and Powercor support the proposal to establish standard forecasting approaches. They state that it should encourage forecasting issues to be discussed upfront at the framework and approach stage. However, they state that the intention that NSPs are free to submit their own forecast based on methodologies other than those in the framework and approach paper is not sufficiently clear in the drafting and should be clarified.[200]

The AER is strongly supportive of the proposal stating that it will support benchmarking and its ability to determine an efficient estimate of forecast costs.[201]

8.3.4 Capex and opex factors

SA Power Networks, CitiPower and Powercor states that "any other factor" should be identified at the framework and approach stage. Such an approach would ensure appropriate consultation and allow parties other than the NSP to be aware of what they may include.[202] In contrast, the AER has submitted that it should be able to consider any other factor prior to the submission of a revised proposal since other relevant factors may arise during the regulatory process after the submission of a regulatory proposal.[203] Energex has also suggested that the factor to refer to the annual benchmarking report refer to benchmarking material more generally, as there may be other info that may be equally relevant.[204] The Energy Supply Association of Australia (ESAA) submitted that in relation to the factor on consumer consultation, it

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

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

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

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

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

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

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

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

will be important to understand how the AER will evaluate supporting evidence. It states that consumer consultation is costly and cost recovery for such activities must also be taken into account.[205]

8.4 Analysis

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

8.4.1 Clarifying the discretion of the regulator

In the draft rule determination the Commission amended clause 6.12.3(f) so it was made clear that the restrictions on the AER's discretion to make substitute decisions did not apply in respect of capex or opex allowances (or, as discussed in chapter 6, rate of return framework). This was determined on the basis that there is no equivalent clause in Chapter 6A and that the AER's interpretation of the clause was imposing a greater constraint on it than intended. Further, the Brattle report identified the wording of the clause as unhelpful, in particular if it were to be interpreted to rule out "top down" adjustments.[206]

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

However, the AER's submission to the draft rule determination states that, despite the carve out of capex and opex allowances, restrictions on the remaining provisions may prevent it from making overall decisions in expenditure allowances. As a result, the AER maintains that the clauses should be deleted such that it can make overall decisions that are aimed at satisfying the NEO.[207] It gives the following reasons:

1. Other decisions affect the capex and opex allowances, such as depreciation, cost inputs and demand forecasts which are subject to the restrictions. As components of the capex and opex allowances, to the extent they remain subject to restrictions, the AER remains restricted in determining the total values. At a minimum, the AER states it creates confusion and uncertainty around how these provisions may operate within a total determination decision.

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

206 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.

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

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

3. There is no clear rationale for the operation of the clauses once it is accepted that capex, opex and rate of return decisions should not be subject to these restrictions.[208]

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

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

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

> “To the extent these clauses oblige the AER to take into account an NSP's proposal, this is already achieved by clauses 6.10(1)(b)(1), 6.11(1)(b)(1), 6A.12.1(a1)(1) and clause 6A.13.1(a1)(1). Further, administrative law requires the AER to have due regard to all relevant information before it when making decisions. The information in an NSP's proposal is *clearly* relevant information.[209] [emphasis added]”

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

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

209 Id., p. 11.

8.4.2 Benchmarking

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

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

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

The ENA states that the important function of the phrase is highlighted by the Tribunal case regarding Powercor's vegetation management.[210] SA Power Networks, CitiPower and Powercor also reference this case by highlighting that the AER is not immune to errors and that the phrase reminds it to have regard to those circumstances which are relevant to any benchmarking exercise. However, the Commission notes that the judgement does not explicitly state which clause, or phrase within a clause, it has based its decision to remit the decision back to the AER. Specifically, the Tribunal stated that the AER's consultant failed to pay proper account of the differences between Powercor's network and work program and those of the other DNSPs.[211]

Annual benchmarking reports

The Commission notes that most stakeholders are supportive of the annual benchmarking reports. It does not accept the reasons provided by Ergon that the AER should have discretion in respect of whether or not to produce/publish such reports.[212]

The intention of a benchmarking assessment is not to normalise for every possible difference in networks. Rather, benchmarking provides a high level overview taking

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

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

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

into account certain exogenous factors. It is then used as a comparative tool to inform assessments about the relative overall efficiency of proposed expenditure. This view is consistent with that put forward in a submission by Grid Australia to the consultation paper.[213] Further, it is intended that the annual benchmarking report will be a useful tool for stakeholders, such as consumers, to engage in the regulatory process and have better information about relative performance of their NSPs. An expectation of annual publication adds to that value. The Commission therefore determines that the annual benchmarking report remain an annual obligation.

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

> "Without systematic and comparable data from all NSPs, the AER will not be able to draw inferences about an individual NSP's performance against a benchmark with sufficient rigor to support is use as an analytical tool informing decisions in pricing reviews. The mere fact of publication of a benchmarking report may not materially improve the AER's pricing determinations.[214]"

The Victorian DPI noted that the SCER has not yet responded to the AEMC's recommendations for improved data collection in the TFP Review. As a result, the Victorian DPI has suggested that the AEMC make a substantially similar rule to support the AER's role in assessing efficient network expenditure.[215] The Commission is sympathetic to the Victorian DPI's concerns, however, it is not appropriate to include such provisions at this stage, as they would not have been subject to consultation. The Commission stresses the importance of quality data collection (including on an annual basis) by the AER to support the changes in this final rule. It notes that this is a point of difference between the AER's practice and that of best practice highlighted by Brattle.[216] As noted in the draft rule determination, the SCER may wish to consider changes to the NEL to facilitate annual data collection by the AER for the purposes of benchmarking reports.

8.4.3 Engagement on expenditure models

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

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

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

215 Id, p. 2

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

from NSPs on a similar basis. The AER is strongly supportive of the draft rule whereas NSPs are strongly opposed to the imposition of forecasting methodologies to address the problems raised.[217] However, there is agreement that early engagement on expenditure models is desirable.[218] Each of these issues is discussed in turn below.

Standard expenditure forecasting model

The ENA raises a number of concerns with the Commission's approach to impose a standard expenditure model. Primarily, these appear to centre around the NSP's role in managing its network and that linkage with the expenditure forecasts. Because of the NSP's role in daily planning and operation of the business, it should be able to produce the best information. Moreover, that the role and responsibility of developing the approach to forecasting should be consistent with the accountability for expenditure outcomes. The ENA further states that this is consistent with internal sign-off that the forecast expenditure reflects the expenditure which is truly required by the NSP.[219]

The Commission accepts that responsibility for developing a NSP's proposal should remain with the NSP. This includes the development of an expenditure forecast in a manner that the NSP views as appropriate. It is the AER's role to assess the NSP's proposal using any tools it views as appropriate. Nevertheless, it remains important for the AER to receive information which enables it to effectively assess a NSP's proposal and be aware of how the NSP plans to forecast its expenditure. The ENA has proposed that the AER develop a guideline for its assessment techniques.[220] The Commission sees merit in this approach.

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

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

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

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

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

220 Id, p. 33.

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

Engagement on NSPs' expenditure forecasting models

The Commission remains of the view that early engagement on expenditure models is desirable. This view is shared by NSPs in submissions.[221] The ENA has proposed an alternative to the Commission's approach in the draft rule determination - that NSPs advise the AER of their forecasting methodologies at the framework and approach stage.[222]

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

> “in a cooperative approach to the conduct of the price review it is incumbent on the service provider and AER to meet early in the review process, and periodically, to discuss relevant matters, including the form of outputs from the service providers expenditure forecasting models.[223]”

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

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

8.4.4 Capex and opex factors

SA Power Networks, CitiPower and Powercor proposed that the inclusion of "any other factor" be identified in the framework and approach paper.[224] The Commission

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

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

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

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

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

The AER submitted that it should be able to raise any other factor prior to the submission of a revised regulatory proposal. This would allow it to consider other relevant factors which may arise after the submission of a NSP's regulatory proposal. It states that there appears to be no justification to exclude any relevant factors so long as the NSP is informed of them up to the cross submissions stage.[225] The Commission sees the potential for relevant factors to arise following the submission of the proposal. However, it does not see that the AER should be able to raise a new factor up to the cross submissions stage. This stage is discretionary and designed to address matters raised in submissions. Accordingly, the clause will be amended to reflect that the AER can raise a new factor up to the submission of a revised regulatory proposal. The Commission considers that the existing capex and opex factors are sufficiently broad that it should be rare that the AER would need to consider additional factors.

Energex has proposed that the factor which requires the AER to have regard to the latest annual benchmarking report be broadened to refer to benchmarking material more generally.[226] The Commission agrees that there may be other benchmarking information available to the AER, some of which may be more relevant than the annual benchmarking report. However, the AER's consideration of such material is not precluded from the rule as in addition to the most recent annual benchmarking report it also states the benchmarking expenditure that would be incurred by an efficient NSP. The consideration of a benchmark NSP enables consideration of broader benchmarking information. As such, the Commission's final rule determination is not to make any changes to this factor.

8.5 Guidance on final rule

8.5.1 Clarifying the discretion of the regulator

The NSP's proposal is necessarily the procedural starting point for the AER to determine a capex or opex allowance.[227] 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

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

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

227 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.

should be only one of a number of inputs. Other stakeholders may also be able to provide relevant information, as will any consultants engaged by the AER. In addition, the AER can conduct its own analysis, including using objective evidence drawn from history, and the performance and experience of comparable NSPs. The techniques the AER may use to conduct this analysis are not limited, and in particular are not confined to the approach taken by the NSP in its proposal.

While the AER must form a view as to whether a NSP's proposal is reasonable, this is not a separate exercise from determining an appropriate substitute in the event the AER decides the proposal is not reasonable. For example, benchmarking the NSP against others will provide an indication of both whether the proposal is reasonable and what a substitute should be. Both the consideration of "reasonable" and the determination of the substitute must be in respect of the total for capex and opex.

The criteria for determining capex and opex contain a requirement that the AER must accept a proposal that is reasonable. It seems almost to go without saying that the AER must accept such a proposal. Why the AER would ever need to reject a proposal that it has determined is reasonable is unclear. The idea of reasonableness was used at times in consultation in 2006 to refer to a "reasonable range".[228] 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.[229] 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.[230] The obligation to accept a reasonable proposal, reflects the obligation that all public decision-makers have to base their decisions on sound reasoning and all relevant information required to be taken into account. Some submissions have referred to the concept of an evidentiary burden, or onus of proof, as some submissions have termed it, that the AER has.[231] 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

228 AEMC, Economic Regulation of Transmission Services, Rule Determination, 16 November 2006, 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.

its proposal, and the AER is required to explain its decision, an evidentiary burden does not appear to reside with one party more than another.

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

8.5.2 Benchmarking

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

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

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

Endogenous factors not to be taken into account may include:

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

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

8.5.3 Engagement on expenditure models

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

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

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

8.5.4 Capex and opex factors

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

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

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

9 Capex incentives

Summary

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

should be able to demonstrate that its capex is efficient. The presence of a strong ex ante incentive could also provide a high level of assurance that capex is efficient.

Difference between draft rule and final rule

- The AER will only be able to preclude capex from going in the RAB from the first regulatory year after the capex incentive guidelines commence. Any capex incurred prior to this time will not subject to this provision.
- The AER will be required to set out in the capex incentive guidelines its approach to assessing whether capitalised expenditure is consistent with the NSP's capitalisation policy.

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 control period. In the regulatory determination, the AER either approves this forecast or does not approve it and replaces it with its own forecast which then becomes the allowance.[232] This allowance is the basis of an incentive for a NSP. If a NSP spends more than its allowance, it bears the costs of this expenditure above the allowance for the remainder of the period.[233] Conversely, if it spends less than its allowance it retains the benefit for the rest of the period.

The AER claimed that the NER provide an incentive for NSPs to spend more than efficient levels of capex for a regulatory control period.[234] This is claimed to be the case particularly where the NSP's allowed rate of return was higher than its actual cost of capital and where the NSP was responding to non-financial incentives it may face. The AER proposed to prescribe in the rules an adjustment to the RAB roll forward such that a NSP could only recover 60 per cent of the cost of any over expenditure (the 60/40 sharing mechanism).[235] It also requested that it be given the discretion to roll forward the RAB using depreciation based on actual or forecast capex as a means of providing an additional incentive. The AER currently has this discretion in Chapter 6 (distribution) but not in Chapter 6A (transmission).

In addition to the broader capex incentive issue, the AER considered that the NER provide an incentive for NSPs to inefficiently incur capitalised related party margins

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

233 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.

234 AER, Rule change request, Part B, 29 September 2011, p. 38.

235 In this chapter, phrases such as capex 'going into the RAB' or being considered at the 'RAB roll forward' are generally referring to the RAB which is adjusted and locked in for the next regulatory control period; Id., p. 40.

and to replace opex with capex through changes to their capitalisation policies during a regulatory control period.[236]

The remainder of this chapter is structured as follows:

- Section 9.2 summarises the Commission's position in the directions paper and draft rule determination;
- Section 9.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 9.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- Section 9.5 provides the guidance on the final rule.

9.2 Directions paper and draft rule determination

9.2.1 Background analysis

In the draft rule determination the Commission did not consider that capex incentives in the NER provide an incentive for NSPs to spend more than their allowance. It noted in the directions paper that a NSP could make a judgement on a forward looking basis as to the possible difference between its allowed cost of capital and its true cost of capital. This could provide a basis to support an overspend, but capex incentives should not be designed to address cost of capital matters. However, there are factors outside of the NER that may provide incentives for capex beyond the allowance.[237]

Following on from this, the Commission identified two key issues with capex incentives in the NER. These were that:

- the incentive to make efficiency improvements declines during the regulatory control period, which has implications for the timing of capex and substitution between opex and capex; and
- capex above the allowance is subject to a lack of regulatory scrutiny, which means that there is a risk that any expenditure above this allowance may be inefficient.[238]

In addition, further work undertaken for the Commission by Parsons Brinckerhoff identified that there were a number of potential drivers for overspends during a regulatory control period by NSPs. These included for example corporate governance,

236 Id., pp. 53-56; AER response to AEMC queries on AER network regulation rule change proposals, 1 February 2012, pp. 7-10.

237 AEMC, *Consolidated Rule Request - Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. iii.

238 Id., pp. 34, 40, 43.

project delivery risks and uncontrollable events. The Commission observed that the majority of these drivers could be mitigated or at least partly controlled. Some drivers, however, such as unexpected growth in demand for new connections and compliance with unanticipated regulatory obligations or requirements appeared harder to control than others.[239]

Parsons Brinckerhoff considered that the ability to defer expenditure was one of the ways in which some of the more uncontrollable factors might be mitigated. Similarly, it suggested that a NSP was likely to look more closely at options for deferring capex the closer it gets to exceeding its allowance. Parsons Brinckerhoff also noted that:

> "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.[240]"

Nothing in the work that Parsons Brinckerhoff undertook indicated that the current regulatory framework provides NSPs with an incentive to overspend their allowances. However, Parsons Brinckerhoff noted that insufficient regulatory oversight would strengthen the potential for capex overspends through a lack of consequences.[241]

Further work undertaken by the Commission also provided support that the NER provides an incentive to defer capex to the end of a regulatory control period - there was some evidence that both the Victorian DNSPs and Ausgrid had deferred capex until the end of a period.[242]

9.2.2 Overall approach

The Commission's approach to addressing these problems was to provide the AER with a number of "tools" which it can apply as it considers necessary to provide adequate incentives for NSPs to spend capex efficiently. These tools include:

- capex sharing schemes;
- reviews of efficiency of past capex; and

239 Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 2 August 2012.

240 Id., p. 33.

241 Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 22 June 2012, p. 33.

- whether to depreciate the RAB using actual or forecast expenditure to establish a NSP's opening asset base.

These tools should be viewed alongside the ability of the AER, on an ex ante basis, to scrutinise effectively, and if necessary amend, proposed capex as part of the determination process to set efficient allowances in the first place.

The Commission considered that the AER is generally best placed to determine which of the tools can be best used to create incentives for individual NSPs rather than specific approaches being included in the NER. The flexibility inherent in the proposed approach would allow the AER to tailor the incentives to individual NSPs and adapt them over time. This recognises that the best incentives for efficient capex may not be the same for all NSPs or the same over time. However, with greater discretion, there must also be appropriate accountability and transparency to help provide certainty for stakeholders and confidence that the outcomes are in the best interests of consumers.

In seeking to provide this accountability and transparency the draft rule provided for an overall objective for capex incentives that was consistent with the NEO and RPP. This objective describes what the capex incentive regime, as a whole, should aim to achieve. It guides the AER in the development and application of the capex incentive tools. It is also relevant for the appeal body to consider this objective when assessing any merits reviews on elements of the capex incentives regime.

In addition, the Commission determined that the AER should be required to set out its approach to capex incentives in guidelines. This is where the AER would set out the approach to capex sharing schemes, how it would undertake efficiency reviews of past capex and how it would determine whether to use actual or forecast expenditure for the purpose of depreciating the RAB. The draft rule also required the AER to set out how its approach to capex incentives overall met the capex incentive objective thereby requiring it to take a coordinated approach to capex incentives. The specific regulatory determination for each NSP would set out which approaches would apply to the NSP and how.

Finally, the draft rule also required the AER to consider principles in the NER when it develops and then applies each of the tools.

9.2.3 Capex sharing schemes

Capex sharing schemes allow for the sharing of efficiency gains and losses from capital expenditure between NSPs and consumers. In general regulators have approached such schemes by allowing NSPs to retain a set portion of any efficiency gains they make and bear a set portion of any efficiency losses it incurs against the benchmark. Often the benchmark is the allowance set by the regulator. The ratio of sharing of the efficiency gains and losses between the NSP and consumers is known as the incentive

242 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 123-124.

rate. The AER could use capex sharing schemes to set incentives so that the most efficient NSPs earn the highest rewards and those that are inefficient are penalised.

The Commission identified the following benefits with capex sharing schemes in the draft rule determination:

- they encourage appropriate network investment;
- they encourage NSPs to look for efficiencies, such as by innovation;
- they provide an incentive for NSPs to reveal their efficient costs; and
- they can be designed to provide for a continuous incentive, that is, the incentives could be set so that the incentive power is the same no matter in which year of a regulatory control period an investment is made.

In this way, a capex sharing scheme can give the AER greater confidence that capex going into the RAB is efficient.

The Commission noted one potential problem with capex sharing schemes is that it can be difficult to identify whether reductions in capex are from efficiency gains or inefficient deferral. A capex sharing scheme should not encourage actions that would later lead to degradation of network quality and consequent reductions in service quality. It determined that while there may be difficulties in applying these schemes, the benefits should outweigh these difficulties. On balance, it considered there is room for further innovation in this area.

To provide for certainty the Commission considered that the AER should be required to take into account some principles in designing and applying capex sharing schemes. Importantly, the Commission did not support a principle that a capex sharing scheme should be continuous. Although in most cases a continuous incentive is preferable to a declining incentive it considered a principle of this nature could discourage some schemes which are appropriate. For example, a non-continuous scheme may be relevant when considered alongside the other capex incentive tools such as the reviews of efficiency of past capex.[243]

Similarly, the Commission did not consider it appropriate that the AER be required consider whether the a scheme should be "mathematically symmetrical".[244]Such an approach would be overly prescriptive and could prevent some schemes that would be beneficial.

243 A constant incentive power is relevant in capex in order to provide an equal incentive to invest in each year of a regulatory control period. Anything other than an equal incentive may provide incentives for NSPs to defer expenditure, even where it is not efficient to do so. In addition a declining incentive in capex and a constant incentive in opex may encourage inefficient substitution between opex and capex.

244 In this context, mathematical symmetry refers to an improvement or decline in capex relative to a benchmark which is of the same absolute value accruing the same reward or penalty in absolute value terms.

The Commission proposed that the AER should be able to apply schemes in a different way to different NSPs or even to apply different schemes to different NSPs. This would enable the AER to tailor its approach to individual NSPs. So, for example, the AER could apply what were regarded as stronger incentives for NSPs that traditionally spend more than their allowance and weaker incentives where the AER is concerned about inefficient deferral into future regulatory control periods. For the avoidance of doubt, the AER can also develop different schemes for DNSPs and TNSPs.

9.2.4 Reviews of efficiency of past capex

Reviews of the efficiency of past capex generally encompass the regulator determining whether to allow the future recovery of incurred capex. Reviews of the efficiency of past capex are found in many other jurisdictions, and have been widely adopted in Australia.[245]

The Commission took the view in the draft rule determination that reviews of efficiency of past capex are the most direct way of addressing the lack of supervision problem since they give the regulator the chance to check that the capex to be recovered is efficient. In addition, the risk of an inability to recover for inefficient expenditure would provide an incentive for NSPs to avoid inefficient capex. Ex ante incentives may not always provide adequate assurance that capex is efficient. A further check that what is rolled into the RAB is efficient would therefore be in the long term interests of consumers. The review of efficiency of past capex should also assist the AER in determining an appropriate ex ante allowance by permitting it to better understand how efficient a NSP has been in the previous period and what projects it has undertaken. It should also improve understanding of the reasons for any overspends.

Importantly, the Commission considered that if a NSP is well run and its management has in place robust processes for deciding which capex projects to undertake and regularly reviews and reassesses its capex program it should have nothing to fear from a review of its efficiency. Indeed, such a review should act to give the regulator greater confidence about the efficiency of the NSP's future capex projections. It was not convinced that the evidentiary burden for the AER would be any different from the evidentiary burden that the AER has when it considers ex ante allowances.

The Commission proposed two elements to the review of efficiency of past capex tool:

- reducing the amount of capex to go into the RAB; and
- a statement on the efficiency of past capex.

Reducing the amount of capex to go into the RAB for inefficient expenditure

The Commission proposed in the draft rule determination that the AER could only reduce the amount of capex to go into the RAB as a result of a review of efficiency of

245 Id., p. 134.

past capex if the NSP had spent more than its allowance for the relevant period. In addition, the amount of expenditure that the RAB could be reduced by would be restricted to the amount of any expenditure above the allowance for the same period. It would be the AER's decision as to whether it considers it appropriate in the specific circumstances to exercise this power.

The Commission considered that setting the best possible ex ante allowance for capex is important, and that the use of ex ante incentive mechanisms for capex has the potential to provide important incentives for efficiency and innovation in capex that may not occur if reliance was placed on reviews of the efficiency of expenditure after it has occurred. Therefore, it is appropriate for NSPs to only be at risk of capex not going into the RAB if they have overspent the ex ante allowance. This approach would also mitigate any potential for an increase in regulatory risk as a result of the introduction of this tool.

In addition, the Commission considered that if the capex undertaken is the same or very similar to that which the NSP set out in its regulatory proposal then the ex ante assessment of the projects should provide a degree of confidence about the likely efficiency of the expenditure below the allowance. That is, while the nature of the actual capex undertaken need not be identical to what was included in the ex ante allowance, that allowance represents an efficient quantum and expenditure below this amount could be expected to be efficient at an overall level.

Further, given that the ex ante allowance, as a total, represents a forecast of an efficient level of expenditure for the NSP there should be little need for the NSP to spend above this amount in normal circumstances. As the Parsons Brinckerhoff report indicated, while there are often unexpected additional costs for a NSP during a regulatory control period, there will also be unexpected reductions in costs.[246] 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, the Commission suggested there was an argument that no capex above the level of the ex ante allowance should be rolled into the RAB. However, to accommodate unforeseen circumstances where a NSP legitimately spent more than its allowance, the AER should have the ability to make an assessment of the amount of any overspend that may be rolled into the RAB.

In this way, the focus in the draft rule on the overall amount to be rolled into the RAB was intended to encourage the AER to undertake a review of the efficiency of the total capex incurred by the NSP during the specified period rather than just looking at individual projects. The Commission noted that in undertaking a review the AER could consider, among other things, whether the NSP could have avoided spending more than its allowance for the period by deferring projects through re-prioritisation. The draft rule was intended to allow the AER to use a range of analytical techniques to assess the efficiency of capex including benchmarking and the assessment of individual projects. The AER could also consider the effectiveness of the NSP's planning and

246 Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 2 August 2012, p. 33.

prioritisation processes for capex to try and gain assurance about the robustness of its decision-making.

The Commission proposed that the AER should set out in the capex incentive guidelines whether and how it intends to undertake reviews of efficiency to determine whether to reduce the amount of capex to go into the RAB. This approach should take into account the other tools it has.

The draft rule determination set out three key elements of the draft rule.

First, it is significant that the test in the draft rule that the AER must apply in determining whether to reduce the RAB as a result of inefficient expenditure is essentially the same as it is for assessing forecasts of capex on an ex ante allowance - that is, whether or not the expenditure reasonably reflects the capex criteria. This was the appropriate test for the efficiency of capex determined by the AEMC in 2006 and it continues to remain valid. The AER now has several years of experience in applying this test and a body of regulatory precedent has been developed.

Second, in determining whether to reduce the amount to be rolled into the RAB the AER should only take into account information and analysis that the NSP could reasonably be expected to have had access to at the time it undertook the capex.

Finally, whilst an AER decision to reduce the amount of capex to go into the RAB as a result of an inefficient capex overspend would not itself be a constituent decision, it would form part of the constituent decision as to the opening value of the regulatory asset base. As a result, this reduction would be subject to the same consultation process as the determination process and, more significantly, merits review.[247] It is important for accountability that a NSP be able to seek an appeal body's review of any decision to reduce its capex rolled into the RAB in this way. While the decision would be subject to merits review, the Commission considered it is very important that any review of the AER's decision considers as a minimum the totality of its approach to capex incentives. This is because a decision that focussed only on the outcomes of the review of expenditure after it has been incurred, but did not have regard to, for example, any ex ante sharing mechanisms, may reach a conclusion that is not consistent with the overall capex objective and the NEO.

Statement on the overall efficiency of capex being rolled into the RAB

In addition to allowing the AER to reduce the amount of capex to go into the RAB as a result of a review of efficiency of past capex, the Commission proposed in the draft rule determination that the AER be required to make a statement on the overall efficiency of capex going into the RAB in its draft and final regulatory determinations for each NSP. This would require the AER to consider the overall efficiency of capex going into the RAB for all NSPs, not just those that have spent more than their allowance. This recognises the principle that capex below the allowance can still be inefficient.

247 What is subject to merits review in the future will depend on any changes agreed by the SCER after considering the LMR Panel report.

The Commission considered the obligation to make a public statement on the efficiency or otherwise of what is going into the RAB may be useful in terms of providing information and analysis to consumers and their representatives. Undertaking the review itself could be considered beneficial as a complement to ex ante reviews of capex. For a start, it is common practice that these reviews are carried out at the same time as the ex ante allowances are determined for the next regulatory control period. There are good reasons for this. As Brattle has observed in respect of the task of conducting reviews of the efficiency of past capex:

> "in practice, this task is frequently carried out in parallel with reviewing capex forecasts, for example through the use of technical consultants, and perhaps because both tasks require the same data and expertise.[248]"

This obligation was incorporated as part of the overall approach towards a greater focus on the efficiency of NSPs in the NER. In line with the overall approach of giving the AER greater discretion and allowing flexibility, few requirements were included in the draft rule around how the AER must undertake this task. For consistency the overall test for efficiency is the same as that to be applied where the AER considers whether to make a reduction to the capex to be rolled into the RAB, and the same as that currently in the rules for the assessment of an ex ante forecast. The AER should, when it develops its Regulatory Information Notice (RIN), consider the information that it will require to assess the efficiency of capex that has been undertaken during the regulatory control period.

9.2.5 Depreciation

The Commission engaged Economic Insights to provide advice on the incentive effects of using actual versus forecast depreciation when rolling forward the RAB. Economic Insights designed a model to measure how much benefit is retained by a NSP over the life of the asset if it is able to make a saving against the capex allowance or how much is lost if the NSP overspends. This is the "incentive power" and is the portion of any efficiency saving that the NSP keeps. Similarly if the NSP overspends relative to the allowance, it is the proportion of that cost which it bears. The incentive power was calculated for asset lives of 10, 20, 30, 40 and 50 years using both forecast and actual depreciation for comparison.[249]

The results of Economic Insights' modelling indicate:

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;

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248 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.

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

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; and

3. the incentive to make any savings relative to the allowance declines through the regulatory control period and by year five results in no incentive to make savings.[250]

The modelling results confirmed the theoretical assessment of the relative incentive effects of depreciation approaches and analyses put forward in submissions.[251] 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.[252]"

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.[253]"

Economic Insights thus concluded that it would be desirable to accord the AER flexibility in making the choice of depreciation approach in transmission as it currently has in distribution rather than prescribe a particular approach.

Further, the Commission decided that it was appropriate for the AER to have principles that it must take into account when exercising discretion on depreciation.

Therefore, the principles reflected the fact that depreciation is one component of a broader capex incentives arrangement, and that the incentives provided by the choice of depreciation methodology should be coordinated with other incentives for a NSP. For example any capex sharing scheme will be relevant, as this will directly increase

250 Note these results will differ slightly depending on the time of year it is assumed that capex is undertaken. Economic Insights have assumed that capex is incurred at the end of the year: Id., p. 14.

251 ENA, Directions Paper submission, 16 April 2012, p. 33 and ENA, Directions Paper submission, Attachment C, 16 April 2012, p. 8.

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

253 Id., p. 33.

the power of the incentive. The power of the incentive for opex is also a relevant consideration to the extent that opex or elements of opex can be substituted with capex. The view was taken that it was undesirable to have incentives to reduce opex without corresponding incentives to reduce capex such that any reductions in opex can be offset by investments in capex. The draft rule determination also noted the importance that incentives to reduce capex do not provide an incentive that could lead to a decline in service standards below the level valued by customers; the incentives provided by the STPIS should also be considered.

It was noted that the differing incentive rates for assets with economic lives of different lengths under the actual depreciation approach will affect whether it is appropriate to have these differing incentives to the extent that they are substitutable.[254] This was because, should they be substitutable, it may distort investment decisions on input use which may ultimately impact consumers. The Commission decided that it was relevant to also consider both the proportional value of short-lived assets in the asset base and their likely current and future strategic importance to gauge the significance of such a risk.

Finally, in considering the appropriate capex incentive, the Commission took the view that it was also relevant to consider the past performance of the NSP. The AER may wish to apply incentives in a different way to a NSP that has historically overspent due to being inefficient compared to one that has underspent.

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

9.2.6 Related party margins and capitalisation policy changes

Related party margins

In a general sense, related parties are companies that are related to a NSP through common ownership.[255] As identified by Covec, some NSPs engage related parties to perform various tasks. The related party margin refers to the difference between the contract price and the related party's actual direct costs to provide the service and may be capital in nature.[256]

The Commission acknowledged in the draft rule determination that there was a potential incentive for NSPs to incur inefficient capitalised related party margins. It noted that this incentive could be present regardless of whether a NSP spent more than

254 Id., p. 16.

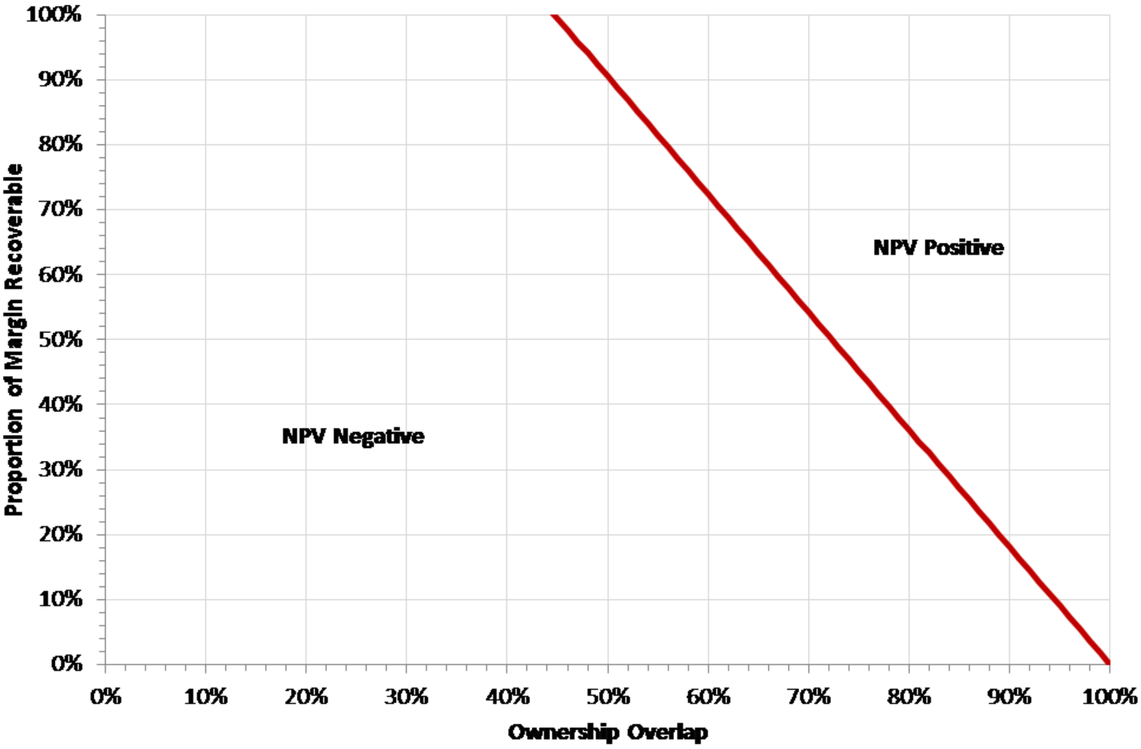
255 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 54.

256 Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers*, Report for the AEMC, 31 May 2012, p. 1.

its allowance or not, and even where there were strong ex ante capex incentives in place such as a capex sharing scheme.

The results of a model developed for the Commission by Covec showed that when a NSP owns a large share of a related party it can be financially beneficial for the NSP to pay an inflated margin, even if something less than 100 per cent of that margin is allowed into the RAB.[257] At smaller ownership shares it showed that it is not financially beneficial to pay an inflated margin, even if there is full pass through of the margin into the RAB.[258] This is illustrated in Figure 9.1 below.

Figure 9.1 Incentives to pay related party margins



Source: Covec, *Analysis of the Use of Related parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, p. 21.

The Commission also referenced analysis undertaken by the AER on this issue.[259] It suggested that this incentive could encourage NSPs to enter into commercial arrangements that are not the most efficient. It noted that the AER and Essential Services Commission of Victoria (ESCV) both felt that there was a need for additional measures to address excessive related party margins.[260] To encourage NSPs to use the most efficient business structure the Commission determined that this issue should be addressed.

257 Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers, Report for the AEMC*, 6 June 2012, p. iii.

258 Ibid.

259 AER, Directions Paper submission, 2 May 2012, p. 28.

260 For a summary of the measures undertaken by the AER and the ESCV see Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers, Report for the AEMC*, 6 June 2012.

The Commission considered that the issue should be dealt with by reviewing the capex after it is undertaken. It therefore proposed to give the AER discretion to reduce the RAB by an amount that reflects the difference between:

- the margin that was paid; and
- the margin that the AER considers would have been paid if the related party margin had been referable to arrangements that had been on arm's length terms.

This is consistent with the capex factor in the NER that the AER must have regard to in determining the ex ante capex allowance.[261] The Commission considered that the AER should have this discretion regardless of whether the NSP spent more than its overall allowance. As noted above, a NSP could gain from inflating related party margins when it spends less than in its allowance as well as when it spends more than its allowance.

The Commission considered that a flexible or NSP-specific approach to determining the efficiency of related party margins would be optimal to recognise the differing incentive power in different circumstances. It put forward that the AER's current approach as described in the Covec report may lack the flexibility to take account of NSP specific circumstances.[262] That is, the AER could better tailor incentives to reflect the different circumstances, and so far as is reasonably possible provide an incentive for NSPs to deliver services in whichever way is most efficient, eg in house, related party providers or third party contractors. The Covec model was an example of how this approach could be developed.

The Commission proposed to require the AER to set out its approach to determining the efficiency of related party margins in the capex incentive guidelines. This would give NSPs and other stakeholders a chance to provide input on the AER's approach outside of the regulatory determination process, promote consistency in the application of the rule between NSPs, and provide greater certainty to NSPs as to how the AER will apply the rule.

Capitalisation policy changes

The Commission accepted that there was a potential incentive for NSPs to capitalise expenditure during a regulatory control period and thus recover the same expenditure twice: once in forecast opex and again through depreciation and return on capital once the expenditure is rolled into the RAB.[263]

Similar to related party margins, the Commission proposed to give the AER discretion to reduce the RAB by an amount that represents expenditure that has been capitalised as a result of within-period changes to the NSPs capitalisation policy. As per related

261 See for example clause 6.5.7(e)(9).

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

263 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 150.

party margins, the AER should have this discretion regardless of whether the NSP has spent more than its overall capex allowance not. This is because a NSP may gain from changing its capitalisation policy regardless of whether its spends more than its allowance or not. The Commission suggested that in general a NSP should be able to avoid having to capitalise expenditure as a result of a change in its capitalisation policy. First, changes to the capitalisation policy in the first two to three years of a forthcoming regulatory control period should be less likely on the basis that they could have been included in the earlier regulatory determination. Second, any changes that a NSP wants to make in the final two to three years of a regulatory control period could be delayed until the start of the next regulatory control period.

9.3 Submissions

This section provides a broad overview of submissions received on the draft rule determination. Specific issues that were raised in response to the draft rule determination are considered in section 9.4.

While NSPs support giving the AER the ability to apply a variety of tools they consider that having a capex incentive objective in the NER is unnecessary given the existence of the NEO.[264] Where they commented, other stakeholders were supportive of the overall approach taken in the draft rule determination.[265]

There was broad support from stakeholders for enabling the AER to develop a capex sharing scheme as one of the capex incentive tools.[266] However, NSPs maintain that the AER should at least be directed to consider the desirability of a continuous and symmetrical incentive in developing these schemes.[267]

There were mixed views on reviews of efficiency of past capex. NSPs maintain that allowing the AER to reduce the RAB as a result of a review of the efficiency of past capex would add to regulatory uncertainty and risk and may therefore encourage NSPs to inefficiently defer or avoid capex. They also note the administrative cost of the reviews. They suggest that if reviews of the efficiency of past capex are to be allowed for then there should be more guidance in the NER as to when and how the AER should apply them.[268]

264 ENA, Draft Rule Determination submission, 4 October 2012, pp. 50-51.

265 AER, Draft Rule Determination submission, 5 October 2012, p. 13; IPART, Draft Rule Determination submission, 2 October 2012, p. 2; MEU, Draft Rule Determination submission, 4 October 2012, p. 25; Energy Australia, Draft Rule Determination submission, 15 October 2012, p. 2.

266 See, for example, ENA, Draft Rule Determination submission, 4 October 2012, p. 55.

267 Ibid; The Commission defines a continuous incentive as one where the incentive power is the same no matter which year of a regulatory control period an investment is made. It considers that mathematical symmetry refers to an improvement or decline in capex relative to a benchmark which is of the same absolute value, accruing the same reward or penalty, in absolute value terms.

268 Id., pp. 50, 59-60.

The majority of other stakeholders that commented are broadly in support of reviews of efficiency of past capex.[269] The IPART, MEU and the SA Minister for Mineral Resources and Energy consider that the mechanism should be broadened to allow the AER to reduce the amount of capex to go into the RAB when a NSP has spent within its allowance.[270] On the other hand, the EUAA and UnitingCare Australia are sceptical about the effect that reviews of efficiency of past capex might have due to the practical difficulties for the regulator in undertaking them.[271] There was also a concern that NSPs may be able to claim higher rates of return as a result of the mechanism.[272]

Few stakeholders commented on the decision to give the AER discretion to use actual or forecast expenditure for the purpose of calculating depreciation to establish the opening regulatory asset base. Grid Australia support the AER having this discretion.[273] Jemena suggest that forecast expenditure should be the default approach.[274]

Stakeholders broadly support the Commission's approach for dealing with capitalised related party margins and capitalisation policy changes.[275]

9.4 Analysis

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

9.4.1 Overall approach

The capex incentive objective

The Commission maintains that the capex incentive objective in the draft rule is appropriate. The ENA's comment that the objective requires the AER to ensure that "no more than" efficient costs are recovered which is inconsistent with the RPP to provide a reasonable opportunity to recover at least efficient costs does not take into account that the objective is a goal that the NER aims to achieve and not a requirement .[276] Further, the RPPs themselves are not requirements but matters that have to be considered by

269 See, for example, Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 3; Origin, Draft Rule Determination submission, 4 October 2012, p. 1.

270 IPART, Draft Rule Determination submission, 2 October 2012, pp. 1-4; MEU, Draft Rule Determination submission, 4 October 2012, pp. 4, 21-23; SA Minister for Mineral Resources and Energy, Draft Rule Determination submission, 15 October 2012, pp. 1-2.

271 EUAA, Draft Rule Determination submission, 3 October 2012, pp. 13-14; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 13-14.

272 Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 13-14.

273 Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 10.

274 Jemena, Draft Rule Determination submission, 4 October 2012, p. 20.

275 See, for example, Id., p. 15; ENA, Draft Rule Determination submission, 4 October 2012, p. 63.

276 ENA, Draft Rule Determination submission, 4 October 2012, p. 51-52.

the AER in making a regulatory determination. There are a number of principles which for some matters have to be weighed up because they suggest weight be given to some factors that may be in conflict.

Content of the capex incentive guidelines

As identified in section 9.2.2 the Commission's general approach is to provide the AER with discretion as to the tools that it should use to provide for appropriate capex incentives and how it uses these tools. This allows the AER to tailor incentives to individual NSPs and adjust them over time. Requiring the AER to set out the criteria that it would use to select the mechanisms it would apply to each NSP as put forward in submissions by NSP would reduce the flexibility inherent in the proposed approach.[277] For example, it could inappropriately restrain the AER from applying or not applying particular mechanisms to particular NSPs at the time of a determination. That said, the AER could elect to provide criteria in the guidelines if it wished to do so.

The process of applying the capex incentive guidelines

The Commission considers that the existing approach to the application of incentive schemes in Chapter 6 of the NER is appropriate for the application of capex sharing schemes and the AER's decision on whether depreciation should be calculated using actual or forecast expenditure for establishing the opening RAB. That is:

- the AER would set out its proposed approach at the framework and approach stage;
- the AER could change its approach during the regulatory determination process; and
- the NSP may propose a different approach during the regulatory determination process.

This will enable a different approach to be adopted if, during the regulatory determination process, it becomes apparent that another approach is more optimal. For example, the AER might want to change its approach to the application of any capex sharing scheme after having received and assessed a NSPs regulatory proposal. Similarly, a NSP may want to propose a different approach in developing its regulatory proposal. However, in general the Commission expects that the application of these aspects of the capex incentive guidelines will be determined at the framework and approach stage in practice. The Commission therefore does not support the position of SA Power Networks, CitiPower and Powercor that the AER should be required to make a final decision on the application of any capex sharing schemes and depreciation at the framework and approach paper stage.[278]

277 Id., p. 52.

278 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 21.

The AER would decide at the time of a regulatory determination on whether to reduce the amount of capex to go into the RAB as a result of a review of the efficiency of past capex. This is discussed in more detail in section 9.4.3.

9.4.2 Capex sharing schemes

The Commission maintains that providing principles that require the AER to consider the need for a continuous and symmetrical incentive in developing a capex sharing scheme could discourage some schemes which are appropriate. This is particularly relevant when considering the capex regime as a whole. For example, the AER might want to adjust the strength of the incentive in certain years of the period to account for possible incentives regarding the timing of expenditure as a result of only allowing the AER to reduce the amount of capex to go into the RAB for inefficient expenditure above the allowance.

If an asymmetric capex sharing scheme is applied, NSPs consider that they should be able to receive compensation through the building block revenue allowance. They suggest that guaranteed service level payments are an example of this approach which provides a positive incentive for NSPs while ensuring consistency with the RPP. While the Commission does not consider that compensation to a NSP through the building block revenue would generally be required for the purpose of a capex sharing scheme, it considers this is something that the AER would decide on at the time of a regulatory determination. This is consistent with the Commission's overall approach to provide the AER with discretion on how to set capex incentives. NSPs also raised this issue in relation to small scale incentive schemes, which is discussed in chapter 11.

9.4.3 Reviews of efficiency of past capex

When the AER can reduce the amount of capex to go into the RAB

As noted in section 9.3, some stakeholders suggest that the AER should be allowed to reduce the amount of capex to go into the RAB when a NSP has spent within its allowance as well as when it spends more. The point was made that just because a NSP has spent less than its allowance it does not necessarily mean that the expenditure is efficient. For example, the reduced spending could have been due to a change in external circumstances during the period. On the other hand, SP AusNet put forward that expenditure as a result of incentives under the STPIS should be carved out when determining whether a NSP has spent more than its allowance.[279]

The Commission does not consider that the review of efficiency mechanism should be broadened as suggested by stakeholders. The approach to be taken is intended to encourage the AER to develop and apply ex ante incentives to reveal the efficient level of capex (including timing of expenditure), so that the review of efficiency of past capex is a last resort option. It would not be desirable that an ex post review becomes the only or main means of ensuring efficient levels of capex. Indeed, the ability to

279 SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 5.

reduce the capex rolled into the RAB is intended for obvious cases of inefficiency, and not as the main means of achieving efficient levels of capex. This approach helps to encourage the development of ex ante incentives. It is also important for the ex ante allowance to have meaning, and if the review of efficiency can be used in the way suggested by these stakeholders the Commission is concerned that both the regulator and the NSP will not focus as much on setting an appropriate ex ante allowance. The ex ante allowance is important because it provides the basis for any ex ante incentives that are put in place and the prices that consumers pay.[280]

In addition, as noted earlier, the Commission considers that the ex ante allowance as a total represents a forecast of an efficient level of expenditure for the NSP and there should generally be little need for the NSP to spend above this amount in normal circumstances. In the event that external circumstances did change to the benefit of the NSP then a well-designed ex ante capex sharing scheme could provide an incentive for the NSP to be efficient. For example, a capex sharing scheme could provide financial incentives for a NSP to be efficient regardless of how much it is forecast to spend as generally the more efficiencies that are made the greater the financial reward for the NSP under such schemes. The ex ante incentive depends in part on how the AER exercises its discretion to implement a capex sharing scheme.

Similarly, the Commission does not consider it appropriate to allow for expenditure relating to incentives provided under the STPIS to be removed from the calculation of the overspending requirement in the NER. A NSP may spend more than its allowance in response to incentives provided under the STPIS and this expenditure may be efficient. However, it should be up to the AER to decide whether to take this into account. If the AER considers this is appropriate then it could set this out in the capex incentive guidelines. For example, the guidelines could set out that the AER would not reduce the amount of capex to be rolled into the RAB if overspending was the result of responding to incentives under the STPIS.

How the AER undertakes the reviews

As set out in the draft rule determination the Commission maintains that it is appropriate that the AER essentially applies the same test for efficiency as the ex ante test in the efficiency review when determining whether to reduce the amount of capex to go into the RAB. In addition, the AER will be required to only consider information that could have reasonably been available to the NSP at the time it undertook the capex.

The Commission notes concerns from some stakeholders on the practical difficulties of reviewing the efficiency of expenditure for the purposes of reducing the amount of capex to go into the RAB.[281] While there can be challenges in such a review the Commission notes that many regulators have undertaken such reviews in the past.

280 Even though there would be a subsequent adjustment to a NSP's revenue to reflect a decision to reduce the amount of capex to go into the RAB it would not necessarily be the same consumers who benefited from this subsequent adjustment as who paid the original charges.

281 See, for example, EUAA, Draft Rule Determination submission, 3 October 2012, p. 13-14.

The Commission intends that if a NSP follows good practice and governance for making investment decisions it should be able to demonstrate to the AER that its capex overall is efficient and should be rolled in to the RAB. The presence of strong ex ante incentives for efficient capex could also provide the AER and customers with a relatively high level of assurance that any capex was likely to be efficiently incurred. The final rule allows the AER to develop ex ante incentives in part because the Commission expects that the use of such incentives could significantly reduce the likelihood of concerns that capex was inefficiently incurred. In this way, any reduction of capex to go into the RAB following a review of efficiency would be a relatively rare occurrence.

The Commission considers that good practice and governance would include a NSP being able to demonstrate that it had high quality processes in place to assess and make investment decisions, that it regularly reviewed future investment plans to assess whether they are still appropriate given changes in key assumptions such as demand forecasts, and that it actively sought the views of its customers about investment requirements. Bearing this overall approach in mind the Commission has set out some examples of how the AER could potentially approach undertaking the reviews of efficiency of past capex. Given that the capex incentive objective seeks to ensure that capex to go into the RAB meets the capex criteria in the NER, applying these techniques in a review of efficiency of past capex should enable this to be achieved.

By way of example, the AER could take a layered approach to undertaking the reviews. At the highest level the AER could consider the overall capex for the period under review and compare this expenditure with the expenditure incurred by other NSPs during the period. It could also consider whether capex is consistent with known changes in key factors affecting expenditure levels, such as forecasts of demand.

At the next level the AER could look at the governance arrangements of the NSP including the decision making processes and procedures that it had in place at the time the decision was made to undertake the capex. Better decision making processes for example could have resulted in better prioritisation and deferral of projects. This stage might also involve looking at the contracting processes used by the NSP - how flexible were the contracts entered into, how much contingency did they provide for?

Depending on the outcomes of the AER's assessments in the first two stages the AER could look at some individual projects to see whether any potential concerns identified in some of the governance and contracting arrangements appeared to raise concerns when applied to projects in practice. It could do this assessment for a sample of projects, bearing in mind that the AER can only reduce the RAB by an amount of any expenditure incurred above the NSP's capex allowance.

In extreme cases where the AER had found evidence of very poor governance processes and the initial sample of projects reviewed verified these concerns it may want to undertake a wider review of projects. While this wider review may not lead to any additional reduction in capex rolled in to the RAB it could provide valuable insights for the AER when reviewing a NSPs proposal for the next determination.

The Commission intends that the AER should not be limited to a bottom-up engineering assessment of individual projects to determine inefficiencies although this type of assessment would also have a potential role to play in any review. As explained above the Commission intends that the initial focus of reviews of efficiency of past capex would be on the governance processes and procedures of the NSP.

The Commission agrees with NSPs that the AER should have regard to the other capex incentives and measures that exist when considering the nature and extent of a review of efficiency.[282] In addition, the AER should also have regard to other factors such as the extent to which a NSP may have spent more than its allowance during previous regulatory control periods. The final rule adequately provides for this by requiring the AER to consider how all of the capex incentive tools taken together are consistent with the capex incentive objective when developing the capex incentive guidelines. This requires the AER to take a coordinated approach to capex incentives.

Capex that is precluded from the RAB that subsequently becomes used and useful

NSPs suggest that the NER need to allow for any disallowed capex to be carried forward where capex is subsequently used and useful.[283] The Commission considers that determining whether capex was subsequently used and useful would be similar to optimising the RAB. As identified in the final rule determination on a rule change put forward by the MEU, the Commission does not support such a review.[284] Amongst other things this would force the AER to take a project by project or asset by asset approach to reviews of efficiency of past capex assessments. Instead it should be an assessment of the total expenditure incurred. Having said this, the AER could take into account the extent to which it expected capex to later become used and useful in determining the amount of any reduction to capex to go into the RAB if it wished to do so. The AER should set this information out in its capex incentive guidelines.

Review of efficiency of past capex and capex undertaken previously

In its consultation paper on savings and transitional arrangements the Commission set out that the discretion for the AER to reduce the amount of capex to go into the RAB as a result of a review of efficiency of past capex would apply immediately following commencement of the final rule. That is, the AER would have the power to reduce the RAB as a result of a review of past capex as part of any regulatory determination which is made by the AER following the commencement of the final rule.[285]

282 ENA, Draft Rule Determination submission, 4 October 2012, pp. 59-60.

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

284 AEMC, *Optimisation of Regulatory Asset Base and the Continued Use of Fully Depreciated Assets*, Rule Determination, 13 September 2012.

285 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, p. 11.

NSPs did not support this approach. They implied that it would not be fair and reasonable and was not consistent with section 33 of schedule 2 of the NEL.[286]

The Commission considers that although NSPs should be undertaking capex in their current regulatory control periods in an efficient manner it agrees that it may not be reasonable to apply the mechanism to all capex incurred in the current regulatory period. This is because NSPs would not have known that the amount of capex to go into the RAB could be reduced as the result of an efficiency review when they undertook the capex for the whole of the current regulatory control period. Therefore NSPs may not have kept information and records that they would have if they had known that they would have been subject to a review. For example, a NSP whose next regulatory control period begins in 2015 would be subject to the possibility of having its opening RAB for the next period reduced to reflect inefficient capex incurred during its current regulatory control period (2010-2015). The NSP would not have known that it would be subject to an ex post efficiency test until the final rule commences in November 2012 and therefore may not have kept records and information on decision making for example to the level that it would have prior to then had it have known that it would be subject to a review.

An input into the consideration of the level of information and records that a NSP considers that it needs to maintain will depend on how the AER proposes to undertake the review as set out in the capex incentive guidelines. This is particularly relevant given that NSPs have no experience of the AER undertaking these types of review before. For these reasons, the Commission considers that it is appropriate that the AER should not be able to reduce the amount of capex to go into the RAB as a result of a review of efficiency of capex for capex that was incurred prior to the AER's first capex incentive guidelines being in place. However, as set out in the consultation paper on savings and transitional arrangements the Commission maintains that the final rules when made should apply to all NSPs as soon as possible.[287] Therefore, the AER will be able to reduce the amount of capex to go into the RAB as a result of a review of efficiency of capex for capex that was incurred in the first regulatory year after commencement of the AER's first capex incentive guidelines. In addition, this change does not affect the requirement for the AER to make a statement on the efficiency of the capex to go into the RAB as part of its draft and final regulatory determination for each NSP - this provision will have immediate effect and will apply to all capex spent by the NSP during its current regulatory control period.

On the basis that rules that give effect to this approach are not needed on an ongoing basis, they are not included in the final rule and but are included in the transitional rules as discussed in chapter 12.

286 Energex, Draft Rule Determination submission, 4 October 2012, p. 2; Jemena, Draft Rule Determination submission, 4 October 2012, pp. 19-20; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 22-23.

287 AEMC, Consolidated Rule Request – Economic Regulation of Network Service Providers, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, p. 7.

The version of the guidelines that will have effect at the time the AER undertakes a review

NSPs have also commented on the version of the guidelines that the AER should be required to apply to reviews of efficiency of past capex. NSPs say the capex incentive guidelines in place at the beginning of the regulatory control period in which the capex being assessed was incurred should be applied - not those that were in place at the time it undertakes a review of efficiency. The ENA and SA Power Networks, CitiPower and Powercor make similar comments in relation to the rate of return guidelines, which are discussed in chapter 4, and related party margins, which are discussed below.

The Commission does not consider it is appropriate to provide this level of precision in the NER. This approach is inflexible and could lead to inefficient outcomes. For example, it would lock-in old versions of guidelines even where there have been improvements to the guidelines to recognise the experience of the AER in applying previous guidelines. It could also result in the AER applying different versions of the guidelines to different NSPs which could be difficult to do in practice and administratively burdensome. Further, the Commission notes that Chapter 6 of the NER provides that the AER should indicate how transitional issues are to be dealt with when it develops and changes its guidelines.[288] The same provision will be added to Chapter 6A of the NER as part of this rule change. This is the appropriate means of dealing with any transitional issues arising from changes to the capex incentive guidelines.

9.4.4 Related party margins and capitalisation policy changes

Related party margins

The Commission maintains that the test in the draft rule for determining whether the RAB should be reduced for capitalised related party margins is appropriate. This is a specific issue pertaining to related party margins and is separate from the general review for efficiency. Among other things the trigger mechanisms are different. The AER does retain the discretion to make a reduction to what is added to the RAB and it might be expected that if a margin not on arm's length terms could otherwise be shown to be efficient the AER would consider this. The Commission's general starting point is that margins on arm's length terms are likely to be efficient. It therefore does not agree with Jemena that the test should be on the prudency and efficiency of the expenditure.[289]

ENA suggests that the AER should be required to take into account the capex incentive guidelines that are in place when the arrangements that gave rise to the margin being paid or payable by the NSP (not those that were in place at the time it undertakes a review of efficiency).[290] Similarly, SA Power Networks, CitiPower and Powercor

288 NER clause 6.2.8(d).

289 Jemena, Draft Rule Determination submission, 4 October 2012, p. 15.

290 ENA, Draft Rule Determination submission, 4 October 2012, pp. 53-54.

consider that the AER should be required to apply the capex incentive guidelines in place at the beginning of the review period in relation to related party margins. As noted in section 9.4.3 the Commission considers it appropriate that the AER should apply the guidelines in place at the time of the review and that the AER has scope to consider transitional issues when revising the guidelines.[291]

SA Power Networks, CitiPower and Powercor also wanted more detail as to what the AER should set out in the guidelines on its approach to determining the efficiency of related party margins.[292] The Commission does not consider that more detail in the NER on this issue is appropriate. It should be up to the AER to develop its approach on this issue taking account of the NEO, the RPP and the capex incentive objective.

Capitalisation policy changes

The draft rule provided that the AER could reduce the amount of capex to go into the RAB for expenditure that was capitalised and was not consistent with the NSP's capitalisation policy at the time of the regulatory determination in which the expenditure was incurred. NSPs consider the draft rule would remove the inappropriately classified expenditure from the RAB without acknowledging it as opex.[293] NSPs suggest this is important because:

- actual opex is an important input into future allowances; and
- it will allow for the proper application of the efficiency benefit sharing scheme (EBSS).

The Commission agrees that actual opex is an important input into future allowances. Indeed actual opex incurred during any preceding regulatory control periods is a factor that the AER has to take into account in deciding whether it is satisfied with a NSP's opex forecast in its regulatory proposal.[294] In principle, the Commission considers that it should be up to the AER to determine whether capitalised expenditure that is not allowed to go into the RAB should be recognised as actual opex for the purpose of setting the opex forecast for the next period. This would be determined by the AER through the regulatory determination process and will depend on the approach adopted by the AER in relation to the opex forecasts. It should also be up to the AER to adjust the allowances in the EBSS to take account of any capitalised expenditure that is not allowed to be rolled into the RAB. Again, it is appropriate that this be determined through the regulatory determination process.

The draft rule did not require the AER to set out its approach to determining whether expenditure has been capitalised consistently with the NSP's capitalisation policy in the capex incentive guidelines. This was because the Commission considered that this test did not require any further specification. In its response to the draft rule determination

291 Ibid.

292 Id., p. 25.

293 ENA, Draft Rule Determination submission, 4 October 2012, p. 63.

294 NER clause 6.5.6(3)(5) and 6A.6.6(e)(5).

NSPs suggest that the AER should be required to set out its approach to capitalised expenditure in the capex incentive guidelines.[295] The Commission accepts that it is appropriate for the AER to set out its approach to assessing capitalised expenditure in the capex incentive guidelines given that this is a part of the capex incentive regime and that the capex incentive guidelines should set out the AER's overall approach to capex incentives in the guidelines.

9.5 Guidance on final rule

The final rule provides the AER with the capacity to use a range of different tools to provide assurance that the level of capex being incurred by NSPs is as efficient as reasonably possible. Given the scope of discretion being afforded to the AER, the Commission considers it helpful to provide some guidance as to how it intends the provisions of the final rule to operate.

9.5.1 Overall approach

The capex incentive objective was formulated to reflect the ex ante test for efficiency of capex that was developed by the Commission in 2006. This means that capex incentives should be designed with the aim that only capex that is efficient should be rolled into the RAB. Efficiency in this context would include trading off investment in new and replacement assets, maintenance of existing assets and other options such as demand side management.[296] It also includes the efficient timing of capex and whether expenditure incurred reflects that which would have been incurred by a prudent NSP. The objective should not act as a mandatory requirement or a prohibition, but a source of direction for the capex incentives regime.

9.5.2 Capex sharing schemes

Process

The process of developing and applying a capex sharing scheme will be as follows:

- the AER may develop a capex sharing scheme or schemes that can be applied to any NSP. This will be set out in the guidelines, which should also explain how the scheme is consistent with the overall capex incentive objective;
- the AER must set out in the framework and approach paper for a NSP its proposed approach to applying any capex sharing scheme to the NSP;
- the NSP proposes how any applicable capex sharing scheme should apply to it in its regulatory proposal. For example, there may be elements that the NSP may propose that are discretionary in the scheme; and

295 ENA, Draft Rule Determination submission, 4 October 2012, p. 53.

296 In practice, efficiency can only be measured by comparison to other companies.

- the AER determines how any applicable capex sharing scheme will apply in its draft and final regulatory determinations for the NSP. For example, the AER could use this stage to set any incentive rate that is to be applied for a NSP.

Principles

The principles will reflect that the neutral position for a NSP achieving its regulated cost of capital is a NSP that is meeting its allowance and that broadly a NSP will be rewarded for improvements in efficiency that result in expenditure less than the allowance and penalised for expenditure more than the allowance. In this way, penalties should not be imposed on NSPs that undertake capex in an efficient manner. That is, the scheme should encourage NSPs to seek out and achieve efficiency improvements over and above those in the allowance. Those improvements should then be appropriately shared between NSPs and consumers. This means that achieving such efficiency improvements under the scheme should be expected to be net present value (NPV) positive for NSPs while also providing benefits for consumers.

While the principles will provide for rewards and penalties, and will not require that there be mathematical symmetry between those rewards and penalties. That is, NSPs should be rewarded with a set portion of any efficiency gains and should be penalised by a set portion of any efficiency losses. For example, a scheme may be designed so that where a NSP is able to undertake its capex program for a regulatory year at $1 million less than the benchmark, 50 per cent of this saving, or $500,000, is reflected in higher revenues. The same scheme may provide that where there is $1 million over the benchmark, the NSP bears the cost of 30 per cent and only $700,000 is recovered in revenues. The AER is required to explain in its guidelines how the scheme is consistent with the capex incentive objective.

The final rule requires the AER to take into account the interaction of the scheme with other incentives such as those relating to service performance, demand management and opex. For example, the AER should consider the impact of the mechanism on substitution of capex for opex. Similarly, it might want to consider adopting a higher powered scheme where it has access to extensive information on service standards. The AER must also take into account the capex objectives, and where relevant the opex objectives in the NER. These objectives include complying with regulatory obligations such as reliability and service standards.

In deciding whether to apply any scheme it has developed and the details of the scheme that should apply, the AER will also be required to take into account all of the same principles and factors that it has to take into account in designing a scheme. In addition, it will have to take into account the capex incentive objective and the relevant circumstances of the NSP. So for example, the AER could take into account the spending history of the NSP when determining whether to apply a scheme and the nature of any scheme. The final rule does not require that any scheme meet all of the factors that the AER is required to take into account, only that the AER takes into account or has regard to the factors. The Commission would expect the AER to explain how it had taken into account or had regard to the various factors. Further discussion on the intended role of objectives and factors is provided in section 5.5

The principles can accommodate different types of schemes. Examples of schemes that would be permitted by the final rule are described in Appendix A. These examples are not meant to limit the way the AER approaches setting capex incentives but to illustrate particular ways that the provisions on capex sharing schemes in the final rule could be implemented.

9.5.3 Reviews of efficiency of past capex

Reduction for inefficient expenditure

The final rule allows the AER to make a reduction in respect of any overspend in relation to the regulatory allowance for a specified period. The process requires that the AER must set out in its capex incentives guidelines how it will approach this.

The years that comprise this period will not match any one regulatory control period. This is because at the time a regulatory proposal is submitted, data on actual capex will not yet be available for every year of the current regulatory control period. This means that the years which comprise the period for analysis should be compared with the relevant regulatory allowance on a like for like basis, for example the same constant dollars and discount factor should be used. Under the current timing for the regulatory process and the extended timeframe set out in the final rule, three years of data from the current regulatory control period will be available at the time of the regulatory proposal assuming a five year regulatory control period. The final rule intends that the period that will be assessed to determine whether an overspend has occurred and reviewed for the purpose of reducing the amount of capex to go into the RAB should comprise:

- the years in the current regulatory control period for which the AER has actual capital expenditure data at the time the NSP submits its regulatory proposal. For example, years one to three of a regulatory control period where the regulatory control period is five years; and
- the last two years of the previous regulatory control period which will not previously have been the subject of a review of efficiency by the AER.

Even though the AER is likely to obtain the data for actual capex of the second last year of the current regulatory control period *during* the regulatory process, there may not be sufficient time for the AER to consider this. Therefore, the actual capex during the second last year of the regulatory control period will not be considered until the following regulatory determination.

As identified above, the AER will be required to set out the manner in which it will determine the amount of any reduction in more detail in the capex incentive guidelines. This could include considerations such as:

- the extent to which projects were evaluated against, and satisfied, the relevant regulatory test;

- the amount of any penalty already imposed on the NSP in respect of the expenditure through a capex sharing scheme, as well as whether the operation of a capex sharing scheme would reduce the likelihood of inefficient overspending. The Commission intends that a reduction to the amount of capex to go into the RAB following a review of efficiency by the AER should be a last resort measure and that primary reliance could be placed on an ex ante incentive to provide assurance that capex is incurred efficiently; and
- the effect of the use of actual rather than forecast depreciation in the RAB roll forward mechanism.

In determining whether an overspend has occurred, the allowance for each year is determined based on the AER's relevant regulatory determination that includes that particular year. Since this will include years in different regulatory control periods different regulatory determinations will be relevant for determining the overall allowance for the years being considered. The overspending requirement will be determined by comparing the capex allowance for the relevant period against total capex incurred. Any decisions relating to cost pass-throughs, capex re-openers and contingent projects are to be applied to adjust the allowance for the purposes of determining if there has been an overspend. In respect of cost pass throughs, this will mean that the AER will need to know the proportion of any cost pass through amount that represents capex, as opposed to opex. The AER may wish to use its information gathering powers to have this information provided with a cost pass-through application. The amount of any overspend determined will be the maximum amount that the AER can reduce the RAB by as a result of a review of efficiency of past capex.

The Commission notes that a NSP could in theory be penalised twice for the same inefficient expenditure if the cause of an overspend was due to capitalised related party margins and/or capitalised expenditure not in accordance with the NSPs capitalisation policy. However, it is expected that the AER would use its discretion appropriately in this circumstance. Similarly, in line with the general approach taken in this rule change, the AER could decide to not reduce the amount of capex going into a NSP's RAB if, after deducting for inefficient related party margins and capitalised expenditure not in accordance with the NSPs capitalisation policy, the NSP would have spent within its allowance. The AER could set this out in the capex incentive guidelines.

As described above, in determining whether expenditure incurred was efficient, the AER must only take into account information and analysis that the NSP could have reasonably been expected to have considered or undertaken at the time that it undertook the relevant capex. The NSP should only be judged on material reasonably available to it at the time, though this would include material available not just at the start of a project but also during it.

If for example the NSP chose the most efficient pole design in 2008 but further studies in 2010 indicated a different pole design would have been more efficient, it would depend on when the project was carried out relative to 2010 in the regulatory control period whether it may be appropriate for the AER to take into account these further studies. As another example, in coming to a decision on whether work was undertaken efficiently the AER could only use unit costs at the time the expenditure was incurred. The AER could not take into account advancements in technology which may have reduced the unit costs of expenditure. One source of information that the AER could use is published forecasts of demand, for example the transmission annual planning report, and it would be reasonable for the AER to expect that NSPs actively and regularly reviewed capex plans based on the most up to date forecasts of demand.

The Commission considers that benchmarking information such as a comparison of actual capex incurred by NSPs during the period would violate the hindsight principle and would not be a basis on its own for the AER to reduce the RAB. However, as discussed in section 9.4.3, this information could be used as an initial sense check to give an indication as to whether further scrutiny of capex was required. In addition, benchmarking information that was available to the NSPs at the time it undertook the capex could be used by the AER for this purpose. For example, if the benchmark cost of building a particular asset at the start of a regulatory control period was $1m but the NSP spent $1.5m the AER could use this information to reduce the amount of capex to go into the RAB if the NSP could not provide justification why it paid more than the benchmark cost. This is because it could be expected that the NSP would have had access to this information at the time that it undertook the capex.

The AER should set out its reasons in the regulatory determination for reducing the capex that would otherwise be rolled into a NSP's RAB consequent upon a review of the efficiency of past capex. If the AER determines a capex overspend has occurred but determines not to make a reduction, the AER should also explain this in the determination in accordance with the consideration of the overall efficiency of what is rolled into the RAB. The Commission intends that if a NSP follows good practice and governance for making investment decisions it should be able to demonstrate to the AER that any capex it has incurred beyond the allowance is efficient and should be rolled in to the RAB.

The AER will not be able to make a reduction to the amount of capex to go into the RAB as a result of a review of efficiency of past capex where the capex was incurred before the commencement of the first capex incentive guidelines. Expenditure incurred in the current period in the first regulatory year after the commencement of the first capex incentive guidelines however may be subject to an efficiency review. This means that, for a NSP whose next regulatory control period commences on 1 January 2015 the AER could reduce the RAB as a result of inefficient expenditure incurred from 30 November 2013 to 31 December 2014 of the current regulatory control period assuming that the AER's capex incentive guidelines commence on 29 November 2013.[297]

297 However, it should be noted that the review of this expenditure would occur as part of the regulatory determination process for the subsequent regulatory control period as this is when the AER would have actual data for this period.

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

The statement on the efficiency of capex to be rolled into the RAB will be independent of the discretion to reduce the capex that is rolled into the RAB. In practice, the AER is likely to conduct these assessments together and use the review of the efficiency of the totality of the capex as part of its consideration of whether to make a reduction in respect of any overspend.

The final rule enables the AER to undertake these reviews in the manner it considers appropriate. In particular, these may be tailored to the circumstances of a particular NSP. A review may be different based on the AER's knowledge of how a particular NSP has undertaken capex in the past, for example. Alternatively, if a NSP has overspent in a particular regulatory control period the AER might choose to undertake a more extensive review than if it had underspent. The review could be based on a top down or bottom up analysis, or some combination of the two. It is expected that NSPs will include justification that past capex is efficient in their regulatory proposals.

9.5.4 Depreciation

The final rule enables the AER to choose the depreciation approach with regard to a number of principles. The principle that refers to the other incentives a NSP has to incur efficient capex is intended to prompt consideration of the totality of those incentives, including incentives outside the NER which may be specific to the NSP. This will provide a guide as to whether additional incentives are required to encourage efficient capex. For the final rule, the Commission accepts the ENA's proposal to broaden the named incentives from the STPIS to any scheme or other incentive. As well, the principle which relates to the efficiency of past capex will also provide a guide as to whether additional incentives are required.

To the extent that additional incentives are deemed appropriate, the principle requiring an examination of the substitution effects of short and long life assets is designed to assess the materiality of the potential distortionary effects of increasing the power of the incentive using depreciation by applying an actual approach. The extent that short-lived assets, such as information technology, can be physically substituted with long-lived assets, such as poles and wires, to achieve similar outcomes in network management should be considered in terms of the ability and the incentive to do so. In turn, a consideration of the benefits of such asset types is intended to address the potential strategic importance of such asset types to avoid potential distortions even if the relative size of the asset class is a small proportion of the capex program.

Substitution possibilities between opex and capex should also be considered for potential distortions as they are included in the capex factors. A consideration of capex factors is to encourage consistency with the overall capex incentive objective. Finally, 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.

9.5.5 Related party margins and capitalisation policy changes

The final rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to deal with related party margins that do not reflect margins that would have been incurred if, in the opinion of the AER, the arrangements had been on arm's length terms. It will be up to the AER to determine whether arrangements that were entered into by the NSP and a third party reflect arm's length terms. Similarly, it will be up to the AER to determine what the margin would have been if it considers the arrangements do not reflect arm's length terms. The AER will be required to set out its proposed approach to related party margins in the capex incentive guidelines. The Commission considers a flexible or NSP specific approach might be adopted to recognise that the incentive power differs in different circumstances and that the Covec model may assist the AER in developing this approach.

The capex incentive guidelines could also include providing greater clarity on what the NSP should report under the information provision relating to this issue.[298] If NSPs do not provide the information required by the AER under the information provision relating to related party margins then the AER may be able to seek the required information through a regulatory information notice.

Similarly, the final rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to reflect capitalised expenditure as a result of changes to the NSPs capitalisation policy during the regulatory control period.

The AER can reduce the capex that would otherwise be rolled into the RAB for these expenditure types regardless of whether a NSP has spent more than its capex allowance. Similarly, the amount by which the AER may reduce the capex that would otherwise be rolled into the RAB for these expenditure types is not limited to the amount of any expenditure above the allowance.

To assist the AER in exercising this discretion, the final rule requires a NSP to include in its regulatory proposal information on margins paid or expected to be paid to related parties and information on expenditure that has been capitalised by NSPs otherwise than in accordance with the capitalisation policy submitted to the AER as part of the NSP's regulatory proposal. As a corollary, the final 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.

As identified in section 9.4.4 the Commission considers it appropriate that the AER should take into account disallowed capitalised expenditure when considering past opex of a NSP to determine its opex allowance. This should be considered as part of the regulatory determination process.

298 Final rule NER clause S6.1.1(6).

By comparison with the general review of efficiency of past capex, for the purpose of related party margins and capitalisation policy changes the AER has more discretion to consider capex where actual data isn't available.

On the other hand, the same arrangements as those for the general review of efficiency of past capex apply in terms of the capex that is subject to assessment following the commencement of the rule. That is, the AER will not be able to make a reduction to the amount of capex to go into the RAB where the capitalised related party margins or capitalised expenditure was incurred before the commencement of the first capex incentive guidelines. Expenditure incurred in the current period in the first regulatory year after the commencement of the first capex incentive guidelines however may be subject to this review.

10 Regulatory determination process

Summary

- The Commission has taken a holistic approach to address broad issues with the current regulatory determination process, with the purpose of improving the consumer engagement process, providing the AER and other stakeholders with an adequate opportunity to consider all relevant and significant material, and making NSPs more accountable.
- To this end, the following incremental changes have been made to the current process that are within the scope of the rule change request:
  - the NSP will provide a consumer-targeted overview paper with its regulatory proposal;
  - the AER will publish an issues paper outlining its preliminary key issues to assist the consumers to focus their resources;
  - the AER will hold a public forum to allow consumers and other stakeholders to engage with the AER and NSP on the regulatory proposal and issues paper;
  - the NSP will identify to the AER specific confidentiality claims in its regulatory proposal;
  - the AER will report such confidentiality claims on its website;
  - the AER will report on its website where it receives late or out-of-scope material from the NSP;
  - the timeframe for the regulatory determination process will be extended by commencing it four months earlier;
  - the time for the NSP to prepare its revised regulatory proposal will be increased;
  - a discretionary cross-submissions stage to target specific issues arising from submissions on the draft regulatory determination or revised regulatory proposal will be introduced;
  - the framework and approach paper will be made optional on particular matters that have been addressed in a previous framework and approach paper; and
  - changing the service classification and formulaic expression of the control mechanism will be based on unforeseen circumstances after the framework and approach paper has been published.

Difference between draft rule and final rule

- In the draft rule, the framework and approach stage and the regulatory determination process were to commence six months earlier than the current arrangements. The final rule further optimises this timeframe so that the framework and approach stage will be completed and the regulatory determination process will commence four months earlier than the current arrangements.
- In the draft rule, the framework and approach stage on a particular component or components would have only been triggered at the AER's discretion. The final rule allows the NSPs to also trigger the framework and approach stage on a particular component or components in addition to the AER.

10.1 Introduction

Regulatory decision-making involves thorough consideration of the regulated business' proposal.[299] It involves providing opportunities for the regulated business and interested stakeholders, including consumers and consumer representative groups, to make submissions to the regulator.[300] It also entails allowing reasonable time for full and thorough analysis of the submissions and the regulator's intermediate decisions.[301] To facilitate this, the NEL sets out the manner in which the AER is to perform its economic regulatory functions or powers.[302] In addition, the NER specify the processes that the AER, NSP and other stakeholders are required to follow as part of the regulatory determination process.[303] A key to effective regulation is the reduction of regulatory risk by providing transparent and timely processes for regulatory determinations.[304] 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.[305] This chapter addresses issues raised by the AER regarding the regulatory determination process, which are outlined below.

10.1.1 Regulatory determination process

To reduce regulatory error under the current regulatory determination process, all stakeholders are permitted to provide submissions at various points throughout the

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

300 Ibid.

301 Ibid.

302 Ibid.

303 Ibid.

304 Ibid.

305 Ibid.

process. The AER was concerned that NSPs are undermining the process by providing material that should be part of an initial or a revised regulatory proposal later in the process in the form of submissions.[306] This does not provide other stakeholders and the AER sufficient time to scrutinise this material.

The AER proposed placing limitations on NSP submissions to address this issue. In particular, the AER proposed rules that would prevent the NSP from making a late initial or revised regulatory proposal in the form of submissions.[307]

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 was concerned that NSPs have been claiming that more information is confidential than is necessary. This, in turn, denies other stakeholders the opportunity to respond to, make an informed comment upon, and scrutinise, all relevant information.[308]

The AER proposed amendments to the NER which would, amongst other things, provide the AER with the discretion to give such weight as it considers appropriate to confidential information. This would apply in an initial or revised regulatory proposal, or in any submissions given to the AER.

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 proposed changes to the content of the framework and approach paper, and when it may be departed from in a final regulatory determination. This would include:

- removing consultation on the application of incentives schemes in the framework and approach paper;
- allowing the AER to change the control mechanism, in addition to service classification, following the framework and approach paper; and

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306 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.

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

308 Id., p. 90.

- 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 Commission's position in the directions paper and draft rule determination;
- Section 10.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 10.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- Section 10.5provides guidance on the final rule.

10.2 Directions paper and draft rule determination

10.2.1 Background

In the directions paper, the Commission set out objectives which it considered underpin the regulatory determination process:

- the AER should be given enough time to scrutinise material provided by a NSP in its initial and revised regulatory proposals. This includes providing a clear period of time to consider all relevant and significant material submitted during a regulatory determination process prior to making the final regulatory determination;
- the regulatory determination process should provide a reasonable opportunity for a NSP and other stakeholders to comment on and scrutinise material submitted by each party;
- the NSP should have sufficient time to prepare its revised regulatory proposal and should submit as much relevant information as possible in its revised regulatory proposal;
- in circumstances where a restriction is imposed on the content of the revised regulatory proposal, the NER should not permit this restriction to be circumvented through the use of submissions; and
- the regulatory determination process should encourage dialogue between the AER, the NSP and other stakeholders, particularly consumers, to establish a common understanding of the issues.

In the draft rule determination, the Commission considered that these key objectives are consistent with the AEMC's Chapter 6A rule determination. They are also consistent with the NEO as they will likely lead to more transparent and robust decision-making, and therefore increased certainty for investment in significant infrastructure for the provision of services.

In addressing the broader issues identified in the directions paper, the Commission decided in the draft rule determination to proceed with the following options:

- reporting late or out-of-scope submissions;
- commencing the regulatory determination process earlier, including extending the timeframe for the NSP to prepare its revised regulatory proposal;
- introducing a discretionary cross-submissions stage;
- requiring a mandatory issues paper from the AER and an overview paper from the NSP;
- identifying and reporting confidentiality claims in the regulatory proposal; and
- making the framework and approach paper an optional stage.[309]

These options were considered to enhance the transparent and timely processes for regulatory determinations, and increase the robustness of regulatory decision-making. They also would address the broader issue of providing all stakeholders with sufficient time and improving stakeholder engagement during the regulatory determination process.

10.2.2 Late or out-of-scope submissions

The AER characterised the problem as being that NSPs are undermining the process by providing late or out-of-scope submissions where they should have included this in their regulatory proposals, and proposed placing limitations on NSP submissions. In the directions paper, the Commission considered the AER's identification of the problem only highlighted a broader issue with the current regulatory determination process. The process is currently not providing all stakeholders with an opportunity to effectively scrutinise material provided by the NSP where the NSP submits further information later in the process. It also does not provide the AER with enough time to assess all relevant material and to make a decision. This late information is greater than was previously envisaged by the AEMC in 2006. There may be legitimate reasons for the provision of information later in the process, such as new information becoming available to the NSP or a material change in the circumstances. However, an increase in the quantity of late material has an adverse effect on the ability of interested parties to be engaged with the regulatory determination process.

309 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.

In the draft rule determination, the Commission decided not to restrict the NSP's provision of material during the regulatory determination process. This was because it would create procedural fairness issues by denying the NSP a reasonable opportunity to make submissions, especially where there are legitimate reasons for making submissions. The Commission considered that restricting the NSP from making submissions in respect of the regulatory determination before it is made would create an inconsistency with sections 16 and 28ZC of the NEL. On this basis, the Commission noted that the AER retracted from its original proposal and was open to making modifications to its proposal to avoid any inconsistencies with the NEL.[310]

Other regulators

The AER's problem with receiving information from the NSP which may be late, out-of-scope or voluminous is not unique. Regulators in general are subject to this as part of their regulatory decision-making processes, although there may be differences in the regulatory framework.

In one example provided in the draft rule determination, the New Zealand Commerce Commission was found by the High Court of New Zealand to only be required to have regard to submissions received in timeframes that the regulator sets.[311] This was following a judicial review sought by the business against the Commerce Commission for rejecting out-of-scope and/or late submissions.[312]

As a regulator, the AER currently has the discretion to not accept such late submissions from the NSP or any other stakeholder.[313] The Commission understood that the Australian Competition Tribunal has previously stated that the AER must draw a line on its engagement with a NSP or it will fail to meet the imposed deadlines.[314] The Commission encouraged the AER where appropriate to utilise its existing powers that are available for any administrative decision-maker to not accept late submissions.

Reporting on late and out-of-scope submissions

With this in mind, the Commission decided a better approach would be for the AER to report on any late or out-of-scope submissions it receives from a NSP. Making public on the AER's website details of late or out-of-scope submissions from the NSP may be an effective tool to discourage such submissions being made. The use of such a tool would increase transparency in this area in that the AER previously did not need to report that it had received a late submission. This approach may also be seen as creating a reputational risk for the NSP if it does decide to make a late or out-of-scope submission.

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

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

312 Ibid.

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

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

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.[315]

10.2.3 Confidentiality claims in the regulatory proposal

AER's existing powers

In the directions paper and draft rule determination, the Commission considered that it is important that the probative value of as much of a NSP's initial or revised regulatory proposal as possible is able to be tested with stakeholders. There will almost always be information included as part of a NSP's initial or revised regulatory proposal which is legitimately claimed to be commercially sensitive and confidential. However, the Commission considered it unlikely that all aspects of an initial or revised regulatory proposal could legitimately be claimed to be confidential, partly because the NSP is a monopoly business and therefore does not compete directly with other businesses.

There also appears to be scope for information to be aggregated where concerns about confidentiality for more detailed aspects of information are present. On this basis, it would be expected that only relatively small parts of the initial or revised regulatory proposal should be commercially sensitive, and therefore confidential.

The NER do not explicitly permit the AER to give less weight to confidential information in an initial or revised regulatory proposal. However, there are existing AER powers under the NEL and common law to use discretion in addressing confidentiality claims in a regulatory proposal. These include:

- giving lesser weight to the information when making a decision;
- aggregating confidential information;
- publishing confidential information if the public benefit outweighs the detriment to the NSP arising as a result of the disclosure of the information; and
- seeking alternative arrangements such as limited disclosure.

The Commission considered that the AER has a broad range of tools at the AER's disposal to assist it in addressing confidentiality claims. The AER should take advantage of its existing discretionary powers.

315 Commencing the regulatory determination process earlier and extending the current timeframe are described in section 10.2.6 of this final rule determination .

Limited timeframe

In the draft rule determination, the Commission considered that an additional six months to the current timeframe as discussed in section 10.2.6 should allow the AER more time to consider confidentiality claims in a regulatory proposal. However, the AER considered that extending the timeframe would not address the problem of a NSP making blanket and unsubstantiated confidentiality claims.[316] Therefore, having more information about the reasons for a confidentiality claim may make it easier for the AER to assess the claim. Categories of confidential information, as described below, may assist this.

Categorisation of confidentiality claims and guidelines

In commenting on the directions paper, NSPs proposed a categorisation of confidentiality claims to assist the AER in assessing confidentiality claims.[317] The Commission considered in the draft rule determination that these confidentiality categories are clearly legitimate reasons for claiming confidentiality as they relate to commercial sensitivities, protection of security, or privacy. However, they should not be considered an exhaustive list, which legislation would still require the AER to protect from being disclosed.[318]

Therefore, the Commission proposed to require the AER to develop and consult on guidelines, which would specify the manner in which the NSP can make confidentiality claims in its regulatory proposal. This may include: categories of confidential information; and how the NSP should identify the confidential information. However, the NSP would not be prevented from making confidentiality claims. The guidelines' purpose is to assist the AER when it receives confidentiality claims from the NSP.

Further, by establishing guidelines which clarify the manner in which NSPs are to make their confidentiality claims: NSPs would have a better understanding of the AER's requirements; NSPs would become more accountable when they make confidentiality claims in regulatory proposals; and the administrative burden on the AER would be eased in addressing confidentiality claims.

In addition to the guidelines, the draft rule required the AER to publish on its website information relating to the proportion of the NSP's material that is subject to a claim of confidentiality. This would allow the public to have an understanding as to the proportion of material that has been claimed to be confidential, as well as a comparison of the proportion of material to other NSPs' claims of confidentiality.

Interaction with interested parties

NSPs proposed in their submissions on the directions paper for a non-rule based solution to the issues raised in respect of confidential information in the form of a

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

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

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

confidential information protocol.[319] In the draft rule determination, the Commission indicated its support for any initiative that aims to improve stakeholder engagement, without the need for prescription in the NER.

With the introduction of the NSP overview paper, discussed below, the Commission considered that this would be the appropriate place to require the NSP to explain whether and, if so, how it has engaged with consumers. This would assist the AER to determine whether it should take a stricter approach in assessing the confidentiality claims from the NSP and how much weight to place on the document.

It would also encourage NSPs to become more disciplined in only making genuine confidentiality claims, clearly identify confidential information to the AER, and reduce the administrative burden on the AER. Other stakeholders would also benefit from a more transparent process and have a greater opportunity to access relevant information. Overall, this would facilitate as much testing and scrutiny of the initial or revised regulatory proposal as possible, while upholding legitimate claims of confidentiality by NSPs. This would lead to a more well-balanced and robust decision-making process.

10.2.4 Mandatory issues paper and overview paper

Issues paper

Consumer representative groups sought in submissions on the rule change request for better opportunities to be engaged in the regulatory determination process. In the directions paper, the Commission identified a need for improvement in engaging with stakeholders during the regulatory determination process, especially with consumer representative groups. This was consistent with the LMR Panel's view that there are weaknesses in the regulatory determination process for consumer and user participation.[320]

Therefore, the Commission considered establishing a mandatory issues paper during the time between the regulatory proposal and close of submissions on the regulatory proposal. This was seen to be for the benefit of stakeholders, including consumer representative groups.

The Commission considered in the draft rule determination that the identification of these preliminary issues would assist all stakeholders to make better use of their resources to focus on particular matters when preparing their submissions on the regulatory proposal. It would also encourage further discussion on these issues earlier in the process and before the publication of the draft regulatory determination. The regulator should also benefit from this process because fundamental differences could be identified and resolved earlier in the regulatory determination process and the quality of submissions should improve. This should lead to an overall improvement in

319 ENA, Directions Paper submission, 16 April 2012, p. 70.

320 LMR Panel, *Review of the Limited Merits Review Regime*, Stage One Report, Report for the SCER, 29 June 2012, p. 45.

stakeholder engagement. For these reasons, the Commission endorsed the mandatory use of an issues paper.

Although optional under the NER, it was acknowledged that the issues paper has never been utilised in practice.[321] This is possibly due to the current limited timeframe between the regulatory proposal and close of submissions on the regulatory proposal. Additional time was therefore provided to the AER to prepare this paper. Using the ESCV's regulatory process as an example, the Commission considered that the AER should be given 40 business days after the submission of the regulatory proposal to make the issues paper.

Overview paper

In the draft rule determination, the Commission also considered the need for the NSP's regulatory proposal to be easier for consumers, including consumer representative groups, to understand. To promote this, the Commission decided that an overview paper should be provided by the NSP. The paper would be subject to preliminary examination together with the regulatory proposal.

The resource intensive nature of the regulatory determination process, especially the volume of information accompanying regulatory proposals and submissions, was recognised. A further burden is placed on resources for consumer representative groups to digest this information and understand the risks, benefits and impacts.

The overview paper would aim to address this by providing a summary of the NSP's regulatory proposal from the NSP's perspective which is specifically directed at electricity consumers. The scope would be to focus on the risks and benefits of the regulatory proposal for electricity consumers. In addition, the paper would outline how the NSP has engaged with consumers and how it has addressed any of their concerns which have been identified as a result of that engagement. Finally, a comparison between the NSP's proposed and current revenue requirements would be made. This was aimed at promoting NSP engagement with electricity consumers earlier in the process. As the NSP overview paper would be consumer-focused, it would need to be presented in plain language that would be easily understood by electricity consumers. Designing the overview paper this way would help to promote better engagement by the NSP with consumers, including consumer representative groups. It would also 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.[322]

Public forum

The Commission considered in the draft rule determination that the requirement to have an overview paper and issues paper should be complemented by a public forum.

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321 NER clauses 6.9.3(b) and 6A.11.3(b).

322 LMR Panel, *Review of the Limited Merits Review Regime, Stage One Report*, Report for the SCER, 29 June 2012, p. 46.

The benefit of this is that it provides an additional opportunity for stakeholders to seek clarification from the AER and NSP on the NSP's regulatory proposal and the AER's preliminary thinking in the issues paper. Further, the forum should assist stakeholders when they prepare their submissions.

Taken together, the AER issues paper, NSP overview paper and associated public forum should improve the level of understanding of the issues and quality of input from stakeholders. These processes add value by assisting stakeholders to allocate their resources to focus on key issues in the regulatory proposal and on the AER's preliminary views.

Notwithstanding the mandatory public forum, the Commission welcomed any other informal engagement between the NSP and AER with stakeholders.

10.2.5 Cross-submission stage

The AER expressed a concern that NSPs are providing submissions on the draft regulatory determination to which other stakeholders do not have a reasonable opportunity to respond. Equally, it could be argued that other stakeholders may raise issues in their submissions which do not allow the NSP to have a formal opportunity to respond. Presently, under the NER, there are no formal consultation processes available following close of submissions on the draft regulatory determination. That said, the Commission noted in the draft rule determination that the AER has used its discretion at times to consult informally with interested parties prior to making a final regulatory determination.

In the draft rule determination, the Commission considered a formal discretionary cross-submissions process to alleviate problems associated with stakeholders not receiving a reasonable opportunity to respond to an NSP submission, and vice versa. The New Zealand Commerce Commission's cross-submissions stage was examined. It was recognised that this is a discretionary stage in which the Commerce Commission can decide to initiate the process based on a narrow scope of issues raised during the initial round of submissions.[323]

The Commission considered the AER's concerns that such a stage could create an additional administrative burden on the AER to consider an additional volume of

323 For example, the Commerce Commission allowed for a cross-submissions stage on its process and issues paper in one of its regulatory process with respect to input methodologies for default price-quality paths with respect to electricity distribution and gas pipeline services. This stage followed immediately after close of submissions on the process and issues paper. Later in that same regulatory process, the Commerce Commission allowed for another cross-submissions stage on its draft input methodology. This second cross-submissions stage occurred immediately after close of submissions on the draft input methodology. NSPs support a cross-submissions stage on the basis that this would provide an opportunity for submissions made by different stakeholders to be tested, and lead to a broader debate between the NSP and other stakeholders. For further information, see New Zealand Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths*, Process and Issues Paper, 9 December 2011, pp. 5, 7, 9, 12, 16; New Zealand Commerce Commission, *Draft Input Methodologies for Default Price-Quality Paths*, Consultation Paper, 15 June 2012, p. 5.

material as a result of the process, and may disincentivise the NSP from providing a complete revised regulatory proposal and submissions upfront within the current timeframes.[324] These could be mitigated by giving the regulator the discretion to initiate the cross-submissions stage, and limiting the scope of the cross-submissions stage to specified matters that have been raised during first round submissions. It would also give the AER the option to dispense with the process if it considers that it would be unnecessary and to better utilise resources in preparing the final regulatory determination.

Overall, the Commission was of the view that providing the NSP and other stakeholders with an opportunity to respond to each other's submissions on specified matters would likely increase the opportunity for all to comment. It would also likely potentially reduce the volume of material that may have otherwise been provided later in the regulatory determination process, which would have been outside of the consultation period. The AER may also benefit in the cross-submissions stage if the cross-submissions provide clarity to the AER on specified matters that were raised in submissions on the draft regulatory determination.

10.2.6 Timing of the regulatory determination process

In the draft rule determination, the Commission noted that the environment for economic regulation of network services has changed since the Chapter 6A rule determination and 11 months for the regulatory determination process appeared to be inadequate. Further, it was recognised that the new additions to the regulatory determination process in the draft rule would require consequential changes to the existing 11-month timeframe.

In addition, the Commission considered extending the time for the NSP to account for a lack of resources over the Christmas to New Year period that was not previously envisaged in 2006. Nevertheless, the Commission pointed out that the NSP should not circumvent the existing requirements by submitting its revised regulatory proposals late.

The Commission decided to allow for an additional 15 business days to the current 30 business day period in which the NSP must submit its revised regulatory proposal and calibration of the timeframes to address the Christmas to New Year period problem.[325] This should provide the NSP with a more reasonable opportunity to prepare and submit a complete revised regulatory proposal.

In the draft rule determination, a total 120 business days, or approximately six months, was added to the existing overall regulatory determination process timeframe. This was to account for the extension in time for existing stages in the process and the addition of new stages. The Commission did not contemplate a shorter additional amount of time as proposed in submissions because it was concerned that this would

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324 AER, Directions Paper submission, 2 May 2012, p. 68.

325 The Commission notes that NSPs propose an additional period of between 10 to 15 business days to prepare their revised regulatory proposals.

reduce the AER's decision-making timeframe and impact on the robustness of its decisions. As a result, a NSP would need to submit its regulatory proposal to the AER at least 19 months, instead of 13 months, before the end of the current regulatory period.

The Commission considered that the benefit of commencing the regulatory determination process earlier by six months would allow for: additional processes to promote further stakeholder engagement and transparency; more time for the existing processes, which should lead to more robust decision-making, more comprehensive and timely submissions; and reduce late material. This would outweigh the risk of less accurate and available information for forecasts.

The Commission compared the new regulatory determination process timeframe with other jurisdictions'.[326] Although it was substantially longer than some, it would still be shorter than Ofgem's 24 month timeframe. Nevertheless, a distinction was made between the regulatory process in terms of the degree of prescription in Australia, and historical developments in economic regulation in Australia.[327]

For consistency, the Commission decided to align the regulatory determination process timeframes for transmission and distribution as part of the improvements made to the process. As a result, the proposed changes included:

- removing the deadline for the making of the draft regulatory determination for transmission where there is currently no such deadline for distribution. This would allow the AER some flexibility in making the draft regulatory determination, which may be desirable given the different individual circumstances of NSPs; and

- changing the deadline for receipt of submissions on the draft regulatory determination for transmission to be no earlier than 40 business days after the publication of the draft regulatory determination. For transmission, the reference date was set at no earlier than 45 business days after the date specified by the AER with respect to the predetermination conference on the draft regulatory determination.

Overall, the AER would still have some flexibility in adjusting the timeframe for specific milestones as it currently does, balanced with the constraint to meet the final deadline for publishing the final regulatory determination.

326 The regulators in other jurisdictions considered were IPART in New South Wales, ERA in Western Australia, Commerce Commission in New Zealand, Ontario Energy Board (OEB) in Ontario and Rhode Island Public Utilities Commission (RIPUC) in Rhode Island. For further information, see The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, p. 4.

327 Here, the regulatory determination process starts from the date when a regulatory proposal is submitted to the regulator to the date that a final regulatory determination is made by that regulator. See The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraphs 12 and 27.

10.2.7 Framework and approach paper

Need for a framework and approach paper

In the directions paper, the Commission considered the NSPs' proposal for a new framework and approach paper to be discretionary if there are no material changes to a particular component of the framework and approach paper.[328] In such a case, there would be no need to revisit such component(s), and the then existing framework and approach paper would be sufficient. This is because the consultation on that component(s) would not provide any additional benefit. As a result, the administrative costs would be reduced by making the process more efficient and flexible. In the draft rule determination, the Commission maintained this position.

The Commission considered that, as the administrative decision-maker, the AER should be responsible for deciding whether to trigger the framework and approach paper. It would be at the AER's discretion to determine how much weight should be given to the NSP's input over other stakeholders with respect to initiating a framework and approach paper. However, it would be most likely that the NSP's input would be the most relevant, given that it has the knowledge of its own network and other matters relevant to the forthcoming regulatory period.

For consistency, the framework and approach paper process would also apply to transmission.

Control mechanism - only relevant to distribution

In the directions paper, the Commission took the view that the AER may need some flexibility to adjust the control mechanism following the framework and approach paper when unforeseen circumstances occur. This was because the AER's proposal highlighted the potential mismatch in the thresholds for changing the control mechanism and the service classification following the relevant framework and approach paper for distribution. Following further clarification from the AER regarding the differences between the form of control mechanism and the formulaic expression of the control mechanism, the Commission decided to revisit this issue in the draft rule determination.[329]

The Commission accepted that the amount of time required for a NSP to accommodate changes to the form of control mechanism would be significant. As a result, the form of control mechanism should be fixed in the framework and approach paper. However, if the formulaic expression of the control mechanism was able to be amended, a measure of flexibility would be afforded.

328 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.

329 Examples of the form of control mechanism can be found under clause 6.2.5(b) of the NER. On the other hand, the formulaic expression of the control mechanism is the formula associated with that form of control mechanism.

The Commission considered that this would provide sufficient flexibility in being able to change the formulaic expression of the control mechanism during the regulatory determination process, balanced with certainty in fixing the form of the control mechanism at the framework and approach paper stage. In addition, the formulaic expression of the control mechanism could be changed if the service classification is changed, addressing the AER's concern.

Threshold for changing service classification and formulaic expression of the control mechanism in regulatory determinations - only relevant to distribution

In respect of changes to service classification, the Commission maintained in the directions paper and draft rule determination that the threshold to allow the AER to depart from its framework and approach paper will be in the event of unforeseen circumstances.

The terms "good reasons" and "persuasive evidence" were seen to be unclear and ambiguous, open to differing interpretations, and create unnecessary uncertainty in the process. On the other hand, the threshold of "unforeseen circumstances" was considered to be more definitive, consistent with other parts of the NER, providing a degree of certainty compared to the "good reasons" and "persuasive evidence" thresholds, and allowing the AER some flexibility where "unforeseen circumstances" arise.[330] The "unforeseen circumstances" threshold would not allow for changes due to reasons which ought to reasonably have been considered at the time that the decision was made in the framework and approach paper.

In addition, the Commission in the directions paper and draft rule determination held that the threshold for departing from the service classification should be the same as that for departing from the formulaic expression of a control mechanism. This suggested an "unforeseen circumstances" test for the formulaic expression of the control mechanism as well.

10.3 Submissions on draft rule determination

10.3.1 Regulatory determination process

The AER, MEU, EnergyAustralia and NSPs generally support the proposed changes to the overall regulatory determination process, including commencing the process earlier, the requirement for an overview paper and issues paper, allowing NSPs more time to submit their revised regulatory proposals, and a cross-submissions stage.[331]

330 For example, the term "unforeseen circumstances" appears under NER rule 3.7A(p)(3) and clause 11.30.2(I)(3). In addition to this, the term "unforeseen" appears under clauses 5.6.2A(b)(7), 5.6.5C(a)(1), 5.6.5C(b), 5.6.5C(c), and S8.11.1(b).

331 AER, Draft Rule Determination submission, 5 October 2012, pp. 17-18; ENA, Draft Rule Determination submission, 4 October 2012, pp. 3-4; EnergyAustralia, Draft Rule Determination submission, 15 October 2012, pp. 2-3; Jemena, Draft Rule Determination submission, 4 October 2012, p. 9; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4

They consider that this should provide for greater consultation and improve consumer engagement.[332] On the other hand, ESAA suggests that NSPs need to understand how the AER intends to evaluate NSPs' evidence on how they engaged with consumers, and recover their costs for consulting with consumers.[333]

Consumer representative groups consider the changes may address some concerns and better inform consumers.[334] Requiring NSPs to report on customer engagement and having the AER take this into account may be meaningful if it is equivalent to the negotiated settlements approach used in some states and provinces of the United States of America and Canada.[335] However, they consider that if this is not the case, then these changes will not improve consumer engagement as they would not be empowered to materially influence the outcomes of the process.[336] The additional stages may create an administrative burden for consumer representative groups with limited resources.[337] The Victorian DPI also expressed similar concerns with respect to the administrative burden placed on the AER and stakeholders as a result of an extended timeframe, suggesting that the overall process could be shortened (eg 12 months for the ESCV) as it has been previously done in other jurisdictions.[338]

NSPs propose further improvements to the process.[339] These include: reinstating submission guidelines for transmission as without this TNSPs would be subject to an administrative burden in changing to the new requirements; separating the deadline for NSP revised regulatory proposals and submissions on the draft regulatory determination from the deadline for stakeholder submissions on the draft regulatory determination, NSP's submission and revised regulatory proposal; and commencing the regulatory determination process in a shorter period than the extended six months to avoid issues of inaccurate and irrelevant information (such as forecasts) in regulatory proposals.[340]

October 2012, p. 30; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 6; MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

332 AER, Draft Rule Determination submission, 5 October 2012, pp. 17-18; ENA, Draft Rule Determination submission, 4 October 2012, pp. 3-4; Jemena, Draft Rule Determination submission, 4 October 2012, p. 9; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 30; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 6; MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

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

334 ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 16-17.

335 Ibid.

336 Ibid.

337 MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

338 Victorian DPI, Draft Rule Determination submission, 2 November 2012, pp. 3-4.

339 ENA, Draft Rule Determination submission, 4 October 2012, pp. 66-68; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 6-7.

340 Ibid.

Other more specific issues related to the discretionary cross-submissions stage occurring after submissions on the revised regulatory proposal closes (if any). The AER supported being given the discretion to trigger this stage on specific issues that may not have been subject to consultation.[341] However, the NSPs did not consider that the stage should be discretionary because the AER may not be in a position to identify the significant issues and the NSPs may not have an opportunity to comment on them if the stage is not mandatory.[342] They consider that there is sufficient constraint on the NSPs to not provide out-of-scope submissions; even so, a more appropriate constraint on the cross-submissions stage would be to limit the scope of submissions made during the cross-submissions stage, rather than giving the AER discretion to trigger the stage.[343] Alternatively, the cross-submissions stage should be made mandatory if the AER uses its discretion to invite submissions on the revised regulatory proposal.[344]

The NSPs also propose for the final regulatory determination to be completed earlier and to increase the period for submitting the DNSPs' pricing proposals.[345] IPART supports this approach, noting that a rule change request has been submitted to the Commission to address the annual pricing proposal framework.[346]

10.3.2 Confidentiality claims

The AER regards the confidentiality guidelines as a way in which it may outline to the NSP what is required when NSPs make confidentiality claims in their regulatory proposals.[347] Ergon Energy sought further clarification that the categories of confidential information would not refer to personal affairs or personal information because this is already covered under other legislation.[348] Although broadly supporting the Commission's approach, the Consumer Action Law Centre considers that more can be done to improve the way in which consumer representative groups are engaged with respect to confidential information such as developing protocols.[349] On the other hand, Origin considers that there will be no reduction in confidentiality claims in regulatory proposals and seeks more stringent requirements.[350]

341 AER, Draft Rule Determination submission, 5 October 2012, p. 18.

342 ENA, Draft Rule Determination submission, 4 October 2012, p. 67; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 30-31.

343 Ibid.

344 Ibid.

345 ENA, Draft Rule Determination submission, 4 October 2012, p. 68.

346 IPART, Draft Rule Determination submission, 2 October 2012, pp. 1, 4-5.

347 AER, Draft Rule Determination submission, 5 October 2012, p. 18.

348 Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 9.

349 Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4.

350 Origin, Draft Rule Determination submission, 4 October 2012, p. 2.

10.3.3 Framework and approach

Need for a framework and approach paper

The AER supports the optional framework and approach stage to apply to distribution and transmission.[351] However, the NSPs consider that this stage should be mandatory because: the AER is being given the sole discretion to trigger the stage without equal input from NSPs; the need for NSPs to prepare for new components or changes to existing components in the framework and approach paper, especially with the expanded scope of the framework and approach; and simplicity of drafting.[352] On the other hand, NSPs would accept an optional framework and approach stage if they were given equal discretion as the AER to trigger the stage, while third party stakeholders can also submit on whether they consider a framework and approach stage is necessary.[353] TNSPs also object to the new requirement for a framework and approach stage in transmission as they consider harmonising the historical differences in forms of regulation and price control for standard control services is unique to distribution, and transmission is already mature and homogenous enough without the need for a framework and approach stage.[354]

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

NSPs maintain their position that the threshold for changing service classification and the formulaic expression of the control mechanism in regulatory determinations should be based on new evidence becoming available after the framework and approach stage which would justify departure from that stage ie persuasive evidence.[355] They provide examples where it would be foreseeable, yet would justify a departure, such as: competition in the provision of alternative control services being foreseeable but its impact on the market not being crystallised until after the framework and approach stage; and a contingent project trigger event occurring which would be foreseeable and require a change in the service classification.[356]

10.4 Analysis

As in the draft rule determination, the Commission's general approach to this rule change request has been to provide the AER with more discretion. Unlike rate of return or capex incentives, however, in respect of the regulatory determination process there are less risks of additional prescription in the NER. In particular, there should be less need for regular changes to the regulatory determination process to adapt to changing

351 AER, Draft Rule Determination submission, 5 October 2012, p. 18.

352 ENA, Draft Rule Determination submission, 4 October 2012, pp. 8, 73-74.

353 Ibid.

354 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12-13.

355 ENA, Draft Rule Determination submission, 4 October 2012, pp. 74-75.

356 Ibid.

circumstances. To allow stakeholders to properly plan, certainty is also very important for the regulatory determination process.

Nonetheless, the current NER or final rule does 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.[357] Further, the NER only provide a framework towards effective engagement; it should be seen as a minimum in terms of the level of engagement. The extent of interaction between the NSP, the AER and other stakeholders is up to those parties. For instance, the AER and NSP should be engaging with each other regularly on an informal basis, including outside of the regulatory determination process. NSPs can, and should, be engaging with consumers and other stakeholders in their network areas outside of the process as well.

As a general rule, the Commission will not be prescribing in the NER requirements where a regulatory requirement already exists via the NEL or common law. The Commission considers that giving the AER discretions, which are a general function of regulators or are already set out in the NEL, should be avoided where possible. This is especially so where it is clear that they would still exist in the absence of the NER and including them in the NER would not provide any additional value. This general approach avoids any potential conflict between the NER and the NEL or common law, especially if the NEL or common law position were to change in the future.

10.4.1 Regulatory determination process

Consumer engagement

The Commission notes the consumer representative groups' dissatisfaction with the draft rule changes made to the regulatory determination process to meet their need for empowerment in influencing the outcomes of the process.[358] The changes in the draft determination were intended to improve transparency and accountability, increase consultation and therefore scrutiny of information submitted during the process, and provide for more robust decision-making within the scope of the rule change. The Commission does not purport to address larger consumer related issues such as lack of resources, expertise or funding which is, as a number of consumer representatives point out, a role for the policy maker.[359] For instance, the Commission has

357 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.

358 ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 16-17.

359 Ibid.

recommended to the SCER the creation of a national peak consumer body.[360] However, where possible, the Commission will be endeavouring to improve the operation of the rules to assist consumers to be better engaged. The Commission notes that this has not been opposed by any stakeholder throughout the process, but rather has been fully accepted as a given. Therefore, amongst other changes, improving the regulatory determination process will be for the benefit of all parties, especially consumer representative groups, in requiring NSPs to submit overview papers, requiring the AER to publish issues papers, holding mandatory public forums, extending time for consultation, and providing for a discretionary cross-submissions stage. As the Commission noted in its draft rule determination, though, the regulatory determination process only provides a minimum framework in which the AER and NSPs can engage with each other as well as with other stakeholders such as consumers. In the end, it is up to all parties involved to engage in good faith, which the NER cannot prescribe.

With respect to the consumer representative groups' preferred negotiated settlements approach, the scope for full negotiated settlements between consumers and NSPs is beyond what the Commission could reasonably consider being within scope for this rule change process.[361] Instead, changes to effect the consumer representative groups' preferred approach are better addressed outside of this rule change process as part of the broader development of a stronger consumer role. This rule change process can be considered as part of this broader development.

Commencement of the regulatory determination process

The Commission notes the concerns expressed by some NSPs that the earlier the regulatory determination process commences, the less accurate and relevant the forecast expenditure and other information will be in the NSP's regulatory proposal.[362] The Commission maintains that improvements in the regulatory determination process will require it to commence earlier than the current arrangements. This will avoid reducing the existing length of time for the AER to prepare its draft and final regulatory determinations as it could impact on the robustness of its decision-making. However, the Commission has identified ways to further optimise the timing without necessarily impacting on the AER's time to prepare and make decisions, as well as providing NSPs and other stakeholders with sufficient opportunities to make submissions during the process.

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360 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 155.

361 ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 17.

362 ENA, Draft Rule Determination submission, 4 October 2012, pp. 66-68; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 6-7.

A minor reduction will be made to the timeframe so that stakeholders now have 30 business days (instead of 60 business days under the draft rule) after the publication of the issues paper to make a submission on the regulatory proposal and issues paper. This means there will be an overall timeframe of 70 business days for submissions to be made on the regulatory proposal (as opposed to 100 business days under the draft rule). The public forum will also be 10 business days after the issues paper is published (as opposed to 20 business days under the draft rule), while the time between the public forum and close of first round submissions will be 20 business days. Nevertheless, the overall timeframe will still be greater than the existing arrangements.

With respect to the NSPs' proposal to create two separate stages for submissions on the draft regulatory determination, the Commission considers that this is not necessary, given that the cross-submissions stage may be triggered by the AER to address specific issues raised in submissions that it considers further consultation is required.[363] In addition, the AER has the discretion to choose the time by which stakeholders must make a submission on the draft regulatory determination and revised regulatory proposal, which can be after the date when the revised regulatory proposal is submitted.

Instead of the separate steps for submissions, the Commission has decided to align the minimum timeframe for making submissions on the draft regulatory determination with the maximum timeframe for the NSP to submit its revised regulatory proposal. This will mean that, at a minimum, the deadline for submissions on the draft regulatory determination can occur at the same time as the NSP's submission of the revised regulatory proposal (if required) is due; otherwise, the AER can decide to extend the deadline for submissions on the draft regulatory determination to a time after the NSP submits its revised regulatory proposal (if required). Therefore, the proposed 40 business days for submissions on the draft regulatory determination (as specified in the draft rule) will be changed to a minimum of 45 business days. Further, the alignment between the minimum time to make submissions on the draft regulatory determination and the maximum time for NSP's submission of its revised regulatory proposal will now be consistent with the current arrangements.

As a result of these minor amendments to the extended time for the regulatory determination process, the overall timeframe will be four months earlier than the current arrangements (as opposed to six months under the draft rule). An advantage for most NSPs is that their regulatory proposals will not be due between the Christmas and New Year period. Although this may not alleviate some of the concerns from NSPs regarding inaccurate information, the consideration of this reduction has been balanced with the need for allowing the improvements to the overall regulatory determination process. Therefore, the NSP will need to submit its regulatory proposal to the AER at least 17 months, instead of 13 months, before the end of the current regulatory period.

363 Ibid.

Completion of the regulatory determination process

In terms of the NSPs' proposal for the regulatory determination process to be completed earlier to reduce the burden related to the pricing proposal process, the Commission notes that this is outside the scope of this rule change process.[364] As noted in the IPART submission, a separate rule change request has been submitted on the annual pricing proposal framework.[365] The Commission's Power of Choice review has also made a draft recommendation to allow sufficient time in the current annual tariff setting process for the AER to monitor DNSPs with respect to actively developing and improving their tariff structures to meet revised pricing principles as best as possible at all times.[366] Therefore, the final rule does not address the issues associated with completing the regulatory determination process earlier. That said, the arrangements will be flexible in the sense that the final regulatory determination will be required to be completed no later than two months before the end of the regulatory control period, which will allow the AER the discretion to complete the final regulatory determination before that time.

Cross-submissions stage

The Commission notes the NSPs' concern with giving the AER discretion to trigger the cross-submissions stage with the view that this step should be mandatory and limited in scope.[367] In developing the cross-submissions stage, the Commission took into account the New Zealand Commerce Commission's approach, which NSPs originally relied on as the basis for their proposal. The Commission considers that the reason the cross-submissions stage has been implemented with great effect in New Zealand is that it is at the discretion of the regulator to trigger that stage and the scope of it is limited according to the submissions provided from stakeholders.

Further, if the stage was mandatory, this could create another opportunity for NSPs to make late submissions. NSPs consider that this could be discouraged by limiting the scope of submissions as well as the AER's reporting of late or out-of-scope submissions.[368] However, the Commission considers that making it a discretionary stage and limiting the scope are complementary tools which the AER can use to implement the cross-submissions stage.

The NSPs' concern that the AER may not be able to fully understand or identify the relevant significant issues can be alleviated in other ways which does not necessitate prescription of a more lenient cross-submissions stage.[369] The Commission has stated that the regulatory determination process should be considered as a minimum

364 ENA, Draft Rule Determination submission, 4 October 2012, p. 68.

365 IPART, Draft Rule Determination submission, 2 October 2012, pp. 1, 4-5.

366 AEMC, *Power of choice - giving consumers options in the way they use electricity*, Draft Report, 6 September 2012, p. 109.

367 ENA, Draft Rule Determination submission, 4 October 2012, p. 67; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 30-31.

368 Ibid.

369 Ibid.

standard to which the AER and NSPs can engage in the process. Outside of this, NSPs and the AER should be engaging with each other informally. The need for the AER to understand the NSPs' concern as to its significant issues can therefore be addressed by informal communication between the NSP and the AER. A formal cross-submissions stage should not be seen as a substitute for good regulatory practice, including dealing with procedural fairness issues, for all of the parties involved.

Submission guidelines

As a general rule, the Commission has taken the view that where there is no substantive reason for any difference in the regulation between transmission and distribution, then there should be an alignment between the two. In examining the differences between the submission guidelines and the later arrangements under Chapter 6 which incorporate the RIN, the Commission considers that the arrangements can be better aligned. The Commission considers that applying two different instruments to achieve the same purpose is administratively inefficient and has therefore decided that it should be aligned in the form of the RIN with consequential changes to the NER. The TNSPs' objections to replacing submission guidelines with the RIN for reasons of administrative costs and lack of benefit of alignment are outweighed by the long term benefit to customers in having a consistent regime in which the AER can regulate in a consistent manner and other stakeholders can be better engaged by following a consistent regulatory determination process.[370]

10.4.2 Confidentiality claims in the regulatory proposal

The Commission notes Origin's particular issue that the confidentiality claims will not be reduced through the draft rule.[371] As previously stated, the Commission considers that the AER currently has sufficient authority under the NEL and common law to address confidentiality claims made in regulatory proposals. The draft rule was not intended to displace those arrangements. However, additional tools will be provided to the AER in the form of confidentiality guidelines. These will include: the AER to specify the manner in which confidentiality claims to be made by NSPs in their regulatory proposals; the need for the NSP to identify their confidentiality claims; and the AER to report on confidentiality claims on its website. Together, these provide additional incentives for NSPs to be more accountable in providing genuine confidentiality claims and the AER with some tools additional to its existing powers under the NEL and common law in addressing confidentiality claims.

The Consumer Action Law Centre also claims more can be done with respect to confidentiality claims by requiring confidentiality protocols to be put in place by the NSP.[372] However, as the Commission stated in its draft rule determination, this is unnecessary as the NSPs and the AER could be doing this as part of its stakeholder engagement plan without the need for prescription in the NER.

370 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14.

371 Origin, Draft Rule Determination submission, 4 October 2012, p. 2.

372 Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4.

10.4.3 Framework and approach

Need for the framework and approach stage

With respect to the approach in the draft rule determination which provided the AER with the sole responsibility to trigger the framework and approach stage and not the NSP, the Commission recognises the NSPs may be in a better position at times to understand whether there should be a need for any new components or changes to existing components in the framework and approach paper. For this reason, the Commission accepts the NSPs' submission to also be able to trigger the framework and approach stage.[373] This means that the NSP will need to advise the AER on whether it considers there is a need for the stage and that the NSP can trigger the stage. The difference between the steps for the AER to trigger the process compared to NSPs is that the NSP will only be required to notify the AER by a certain date, while the AER will still be required to consult on particular components not triggered by the NSP. The AER should take into account the interests of third parties such as consumers in deciding whether it will trigger the framework and approach stage.

Introduction into transmission

With respect to TNSPs' objection to the introduction of the framework and approach stage into transmission, the Commission has applied the same position as it has for distribution.[374] For transmission, new incentive schemes and information requirements for forecast expenditure assessments will now be addressed, which will be covered in the framework and approach stage.[375] The advantage of having a framework and approach paper for transmission is that it encourages engagement earlier in the process, especially with third parties such as consumer representatives, and therefore reduces the amount of information to be considered later in the regulatory determination process. As a result, it should increase administrative efficiency in the process. Further, as stated earlier, where there is no substantive reason for any difference in the regulation between transmission and distribution, then there should be an alignment between the two.

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

The Commission notes the ENA's examples where it considers the unforeseen circumstances test to be inappropriate eg where development of competition may be foreseeable at the time but its impact on the market is unknown, and where a contingent project trigger event occurs which would require alteration of the service classification.[376] With the former example, if development of competition may be foreseeable at the time but its impact on the market is unknown, the impact on the market can still be regarded as unforeseeable. Otherwise if the impact on the market

373 ENA, Draft Rule Determination submission, 4 October 2012, pp. 8, 73-74.

374 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12-13.

375 NSPs will also be required to advise the AER of their approach to expenditure forecasting.

376 ENA, Draft Rule Determination submission, 4 October 2012, pp. 74-75.

was foreseeable, then appropriate service classification should have been made during the framework and approach stage.

Likewise, the contingent project may be foreseeable at the time although its scope and cost is unknown, but the change in service classification can still be regarded as unforeseeable. Otherwise if the change in service classification was foreseeable, then appropriate service classification should have been made during the framework and approach stage.

For both of the above examples, the Commission notes that the AER has the responsibility to consider whether a change in circumstances was foreseeable or unforeseeable. The Commission maintains the view that the unforeseen circumstances test is adequate.

10.5 Guidance on final rule

10.5.1 Late or out-of-scope submissions

If the AER receives a late or out-of-scope submission from a NSP, the AER is required to make available on its website the following information:

- the identity of the NSP who made the late or out-of-scope submission;
- a summary of the particular information it considers to be late or out-of-scope;[377] and
- an indication of the amount or length of that information that it considers to be late or out-of-scope.

In addition to the above, the NSP may wish to informally respond to the AER to explain its reasons for providing such a submission once it is made aware of the AER's position.

10.5.2 Confidentiality claims in the regulatory proposal

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

377 For instance, the summary may simply cross refer to that information as contained in the submission.

Once the guidelines are in place, the NSP is required to identify to the AER which information it claims to be confidential. This may include identifying the category of confidentiality claim that the NSP wishes to make. Based upon this information, the AER is able to determine the comparative proportion of material that has been claimed as confidential with regard to other NSPs. The AER can then report on its website that a confidentiality claim has been made. Other information on the website include:

- the identification of the NSP;
- the quantity and proportion of confidential information; and
- a comparison of the NSP's proportion of confidential information to other NSPs.

The AER will not be required to report on other more specific aspects such as categories of confidentiality claims. That type of information is more for the AER's benefit when addressing confidentiality claims.

As an example, the AER provided a table in a previous submission to demonstrate the proportion of material from NSPs that it has previously received claiming to be confidential.[378] 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.

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 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.[379] However, no consequential amendments have been made to the NER to align confidentiality claims in respect of submissions with the Commission's position on regulatory proposals. This is because the NER provisions relating to confidentiality claims in submissions already exist. Conversely, the Commission considers it appropriate to treat confidentiality

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

379 Pricing methodologies are submitted with the regulatory proposal in transmission.

claims in respect of pricing methodologies for transmission consistently with confidentiality claims in respect of regulatory proposals.

10.5.3 Mandatory issues paper and overview paper

Issues paper

The Commission has decided to require the AER to publish an issues paper. The purpose of the paper is to identify the preliminary issues that the AER considers are likely to be relevant to its assessment of the NSP's regulatory proposal. However, the AER is not precluded from considering other issues when making its regulatory determination. Therefore, the issues paper is not an exhaustive review of the proposal and does not contain a complete list of the matters that the regulator would consider in making its final regulatory determination.

The issues paper is published within 40 business days of the AER receiving the NSP's regulatory proposal. It is noted that the publication date for the issues paper is not based on when a resubmitted regulatory proposal, if required to be resubmitted, is received by the AER. This is because the AER can still prepare the issues paper while it waits on further information to be included in the resubmitted regulatory proposal. Therefore, only the period between the resubmitted regulatory proposal and issues paper is affected. Besides the public forum on the issues paper, the other milestones in the regulatory determination process are not contingent on the date that the issues paper is published.

The deadline for submissions on the issues paper and regulatory proposal is required to be no earlier than 30 business days after the AER publishes its issues paper. This means that the deadline for submissions on the regulatory proposal is essentially no earlier than 70 business days after receipt of the regulatory proposal.[380] The additional time for submissions on the regulatory proposal takes into account the introduction of the issues paper and submissions associated with that paper.

Submissions on the issues paper are due at the same time that submissions on the regulatory proposal are due. This reflects the purpose of the issues paper, which is to assist stakeholders, particularly consumers and consumer representative groups, in preparing their submissions on the regulatory proposal.

Overview paper

With a consumer-specific focus in mind, the mandatory overview paper needs to explain how the NSP has engaged with electricity consumers in preparing its regulatory proposal. The paper also provides a summary of the regulatory proposal for electricity consumers. In this way, the overview paper acts as a "map" to the regulatory proposal and helps consumers focus on the relevant parts when responding to the regulatory proposal. In addition, the paper will explain how the NSP has sought to

380 This time also takes into account the 40 business days for the AER to publish its issues paper after receipt of the regulatory proposal.

address any relevant concerns identified as a result of the engagement with electricity consumers. To further focus the attention of consumers, the paper will describe the key risks and benefits of the regulatory proposal for electricity consumers. Finally, the paper will compare the total revenue approved for the current regulatory period with the NSP's proposed total revenue for the next regulatory period. In this regard, the NSP is to provide an explanation for any material differences between these two amounts.

Given that consumers need to be able to easily access the paper, the overview paper is a standalone document provided with the regulatory proposal. This means that the paper is to be in plain language, that is, it must not use technical language or industry jargon.

To reflect the overview paper's importance in the process, the AER will be given the ability to accept or reject the overview paper which accompanies the regulatory proposal. If the AER considers that the overview paper does not comply with the NER requirements, the AER may reject the overview paper and require that this paper be resubmitted, addressing any relevant requirements. To provide clarity to the NSP on the information required in the overview paper, the AER can utilise a regulatory information instrument.

Public forum

The AER will be required to convene a public forum on the NSP's regulatory proposal and the AER's issues paper. This must be held within 10 business days after the AER publishes its issues paper on the NSP's regulatory proposal.

10.5.4 Cross-submissions stage

The final rule provides for a cross-submissions stage in the NER. The AER will have the discretion to decide whether or not the cross-submissions stage is required immediately following the close of submissions on the revised regulatory proposal. If the AER does not invite submissions on the revised regulatory proposal, it implies that the cross-submissions stage is unnecessary. The AER will have the discretion to limit the scope of the cross-submissions stage. The scope is limited to specified matters that have been raised during submissions on the draft regulatory determination or submissions on the revised regulatory proposal. If utilised, the cross-submissions stage allows for at least 15 business days for submissions after the invitation for submissions is published.

10.5.5 Timing of the regulatory determination process

Commencing the regulatory determination process four months earlier, as can be seen in Figure 10.3, will allow for:

- the AER to prepare and publish the issues paper within 40 business days following receipt of the NSP's regulatory proposal;

- stakeholders to submit on the issues paper and regulatory proposal no earlier than 30 business days following the publication of the issues paper;

- a public forum to be held within 10 business days after publication of the issues paper;

- the NSP to submit its revised regulatory proposal within 45 business days after the publication of the draft regulatory determination;

- other stakeholders to submit on the draft regulatory determination no earlier than 45 business days after the publication of the draft regulatory determination; and

- a cross-submissions consultation stage of no earlier than 15 business days.

Figure 10.1and Figure 10.2 are examples of the current regulatory determination process applicable to TNSPs and DNSPs, while Figure 10.3 shows the changed process according to the final rule.

Figure 10.1 Example of the current regulatory determination process applicable to TNSPs (hypothetical dates used)

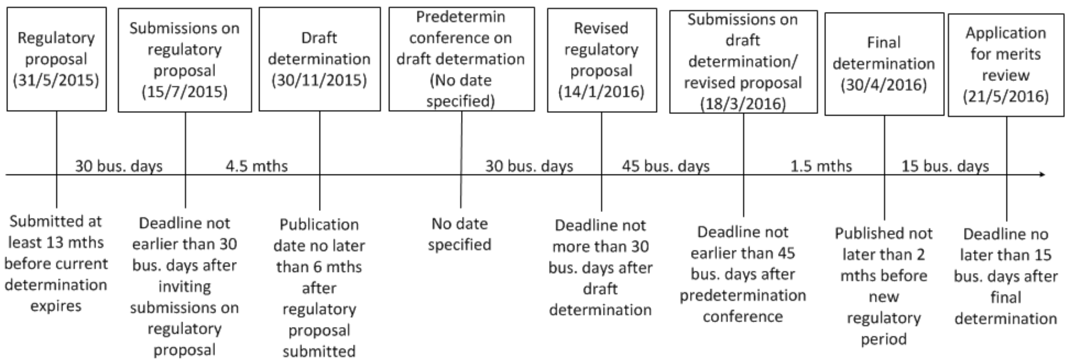
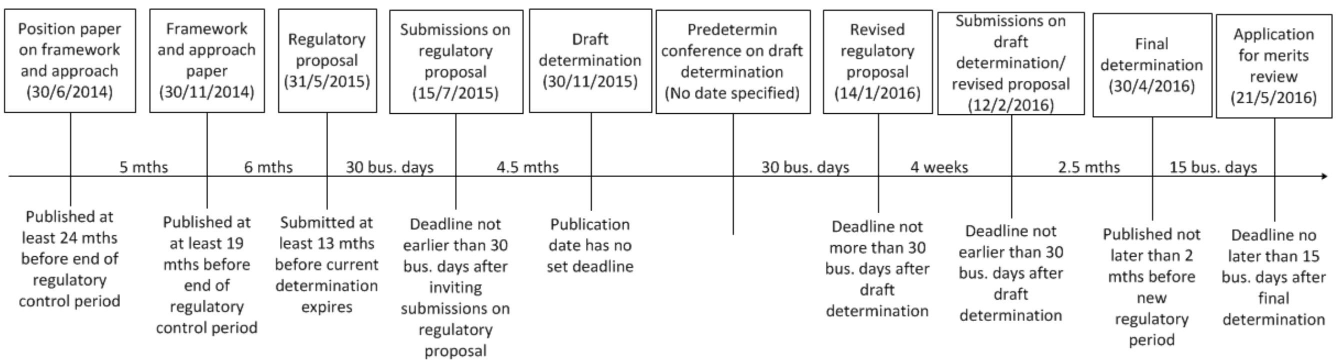
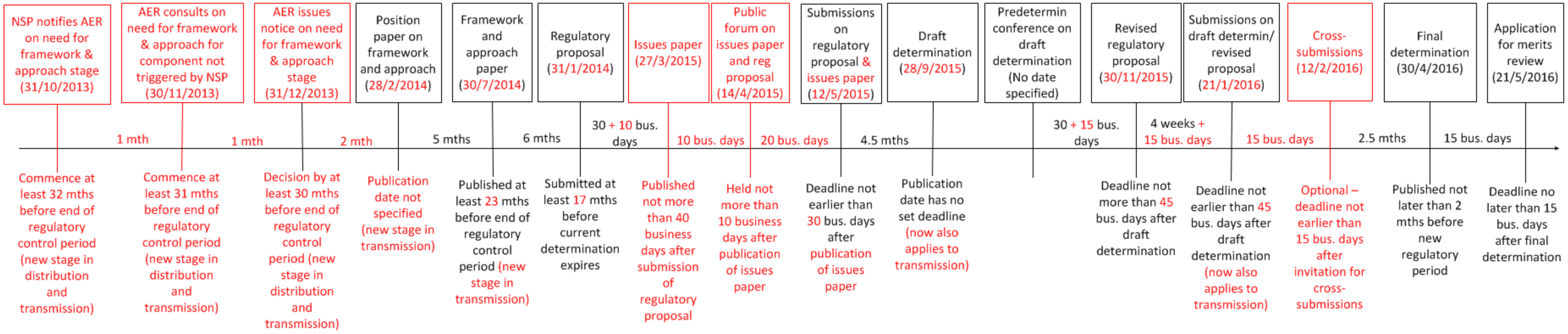


Figure 10.2 Example of the current regulatory determination process applicable to DNSPs (hypothetical dates used)



Note: the dates used in Figure 10.1 and Figure 10.2 are hypothetical and are only used to illustrate the differences between the existing timeframe in these figures and the new timeframe shown in Figure 10.3.

Figure 10.3 Example of the new regulatory determination process applicable to DNSPs and TNSPs (hypothetical dates used)



Note: the dates used in Figure 10.3 are hypothetical; changes to the current regulatory determination process are highlighted in red text.

10.5.6 Framework and approach paper

Triggering the framework and approach paper

The AER or the NSP will have the discretion to trigger the framework and approach paper stage. The circumstances in which the framework and approach stage is required are if:

- there is no previous framework and approach paper on a particular component or components; or
- the AER or NSP decide that a particular component or components from the previous framework and approach paper will be amended or replaced.

The circumstances above require that there must always be in place a framework and approach paper on a particular component or components, even if that is a previously existing framework and approach paper. A corollary of this is that, where a framework and approach paper on a particular component has previously been put in place, the requirement for a framework and approach paper on that particular component or components can be bypassed if the existing framework and approach for that component or components is still appropriate. In other words, the framework and approach paper can only be reopened for the particular components that the AER or the NSP decides should be consulted upon.

Where the AER is considering whether to trigger the framework and approach stage on a particular component or components, the AER has the responsibility to consider all stakeholder comments on whether a revised framework and approach paper is necessary to address a particular component or components. This is done prior to the AER making a decision on whether to trigger the framework and approach paper stage. This gives relevant stakeholders an opportunity to make a submission to the AER. It also promotes transparency in the process. Alternatively, the AER may not receive any submissions on triggering a framework and approach paper on a particular component or the NSP may not trigger a framework and approach paper on a particular component or components, but the AER can still decide to trigger the stage.

To this end, if the AER is deciding whether to trigger the framework and approach stage on a particular component or components, then the AER must:

1. issue an invitation for comment by at least 31 months before the end of the current regulatory period;
2. issue a notice on whether it will trigger the framework and approach stage by at least 30 months before the end of the current regulatory period;
3. then commence consultation on the framework and approach paper on that particular component or components; and

4. have completed and published the framework and approach paper by at least 23 months prior to the end of the current regulatory period.

Alternatively, if the NSP decides to trigger the framework and approach stage on a particular component or components:

1. the NSP is required to notify the AER at least 32 months before the end of the current regulatory period on which particular component or components that should be triggered in the framework and approach stage;

2. the AER must issue an invitation for comment on other components that are not covered by the NSP request by at least 31 months before the end of the current regulatory period;

3. the AER must issue a notice on the NSP's requested components to be considered in the framework and approach stage and whether there are any other particular components that the AER considers is to be considered in the framework and approach stage by at least 30 months before the end of the current regulatory period;

4. the AER must then commence consultation on the framework and approach paper on that particular component or components; and

5. the AER must have completed and published the framework and approach paper by at least 23 months prior to the end of the current regulatory period.

Unlike the steps for the AER to consider whether to trigger the stage, if the NSP triggers the stage on a particular component or components, then the AER is not required to consult with stakeholders on whether to trigger the stage on that particular component or components. In such a scenario, the reason that the NSP will be required to notify the AER at least 32 months before the end of the current regulatory period is to give the AER enough notice so it avoids unnecessarily consulting with other stakeholders on whether to trigger the stage on that particular component or components, which would have occurred one month later but for the NSP triggering the stage. The NSP is to provide reasons to the AER for triggering the stage to assist the AER and other stakeholders when they consider whether other components should be triggered that the NSP had not triggered. Notwithstanding the above, the AER is still required to consult on other components that the NSP does not trigger.

As there must be a framework and approach paper in respect of dual function assets, it is necessary for the determination on the price regulation of dual function assets to be brought forward to be aligned with the framework and approach paper process. To give the AER enough notice, the AER is advised of the value of the relevant dual function assets before it commences consultation on whether to initiate a framework and approach paper. This means that the AER is advised on this value at least 32 months prior to the end of the current regulatory control period. Given that the value ascribed to the relevant dual function assets must correspond to an opening value for a regulatory year, the time as at which this value must be determined needs to be 36 months prior to the end of the current regulatory period.

Threshold for departing from a component in the framework and approach paper

The AER will be able to depart from the framework and approach paper in respect of the components covered by it during the regulatory determination process. For example, service classifications and the formulaic expression of the control mechanisms can depart from the framework and approach paper for unforeseen circumstances. Another example is the AER can depart from the relevant framework and approach paper for the application of incentive schemes during the regulatory determination stage, although it must give reasons for doing so. However, the form of the control mechanism and the pricing of services provided by dual function assets continue to be set as in the framework and approach paper.

An example of how the "unforeseen circumstance" threshold could be applied may be with respect to a pending judicial decision where a service classification is contingent on that decision. Here, the pending judicial decision is one event and the actual judicial decision is another event. Although it may be argued that the pending judicial decision is foreseeable, the actual judicial decision could probably not be reasonably foreseen until the decision has been made. The service classification would have to be based on what is known at the time the framework and approach paper is made, but could be departed from once the actual judicial decision is made. On the other hand, if the judicial decision was foreseeable at the time of the framework and approach stage, then the service classification should have been classified at that stage and it would not be appropriate to depart from this at a later stage as it was foreseeable. Nevertheless, the AER has the responsibility to consider whether a change in circumstances was foreseeable or unforeseeable.

11 Diverse issues

Summary

- The capex reopener and contingent project mechanisms has been introduced in Chapter 6 of the NER (distribution) to allow for efficient costs to be recovered for unexpected events. The contingent project threshold has been set to the greater of $30 million or five per cent of the annual revenue requirement (ARR) or maximum allowed revenue (MAR) for transmission and distribution. A materiality threshold of one per cent of the ARR will apply to cost pass through applications in distribution. These changes will bring the uncertainty regime for distribution into line with transmission.

- The AER's decision-making timeframe for applications made under the uncertainty regime has been aligned between distribution and transmission. Some flexibility has been given in the timeframe to account for complex or difficult issues, and waiting on information from certain third parties. This will provide the appropriate balance between certainty and finality with flexibility in the process.

- The AER's power to revoke and substitute a decision for a material error or deficiency under Chapter 6A has been limited to "computational" errors by the AER or false or misleading information provided to the AER by another party. This will bring into line the AER's power with Chapter 6, as well as providing for finality and certainty in the process.

- The AER has been given the power to establish the shared assets cost adjustment mechanism. This will apply to assets which provide standard control services or prescribed transmission services as well as unregulated services. The shared assets cost adjustment mechanism will be designed in accordance with specific principles and guidelines. This will allow for innovation by NSPs and cost reflectivity for customers of standard control services or prescribed transmission services.

- Balancing the promotion of innovation and flexibility in regulation with good regulatory practice, the AER will be able to develop small scale pilot or test incentive schemes. This will allow the potential impact of such an incentive scheme to be understood before full implementation.

Difference between draft rule and final rule

- In the draft rule, the contingent project thresholds were to be linked to the greater of five per cent of the MAR or ARR and the RIT-T, as varied, for transmission and the proposed RIT-D, as varied, for distribution. In the final rule, the distribution and transmission contingent project thresholds are based on the greater of $30 million or five per cent of the ARR or MAR, respectively.

- In the draft rule, the shared assets cost adjustment mechanism was to only apply to a shared asset providing both standard control services and alternative control services or unregulated services in distribution, and both prescribed transmission services and unregulated services in transmission. The final rule limits the mechanism to a shared asset providing both standard control services and unregulated services in distribution, and both prescribed transmission services and unregulated services in transmission.

11.1 Introduction

The AER raised in its rule change request certain diverse issues. These related to:

- the appropriateness of applying particular uncertainty regime mechanisms in distribution and aligning decision-making timeframes for the uncertainty regime mechanisms;
- when the AER can revoke and substitute regulatory determinations to address material errors;
- how shared assets should be regulated; and
- the development of small scale incentive schemes.

11.1.1 Uncertainty regime

Like most businesses, a NSP operates in an uncertain environment.[381] Uncontrollable external events can alter the quantity and nature of services required to be provided.[382] In a normal competitive environment, production and pricing behaviour would adjust to respond to these changes where efficient producers can recover their costs and should generally earn at least a normal return on their investments.[383] The regulatory arrangements, including the uncertainty regime, attempt to mimic the competitive market by allowing the NSP to alter its production behaviour to meet market demand and undertake unexpected investment in new network capacity.[384]

For the purposes of this final rule determination, the "uncertainty regime" under the NER comprises contingent projects, capex reopeners and pass through events. These mechanisms deal with expenditure that is required to be undertaken during a regulatory period but which is not able to be predicted with reasonable certainty at the time of preparing or submitting a regulatory proposal to the AER for the start of the next regulatory period. A more accessible uncertainty regime will, on the one hand, facilitate certain capex or opex projects being undertaken, though on the other hand it

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381 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 54.

382 Ibid.

383 Ibid.

384 Ibid.

may reduce the incentive to undertake only efficient capex and opex in some circumstances. An appropriate uncertainty regime will contribute to efficiency of investment by allocating risks to the party best able to deal with them, including appropriately sharing the risks of external events.

Capex reopeners and contingent projects

Contingent projects and capex reopeners are not currently included under Chapter 6 for distribution. This was because the MCE Standing Committee of Officials (SCO) considered when developing Chapter 6 that distribution projects were different to transmission with respect to their nature and profile of capex, with uncertainty around certain capex projects to be dealt with via pass through provisions, and the objective that this would strike a reasonable balance between not penalising the DNSP for events outside its control and ensuring appropriate operation of the incentives regime within the regulatory framework.[385]

The AER proposed to include capex reopener and contingent project provisions in Chapter 6 of the NER.[386] In general, these would operate in distribution in the same way as they currently operate in transmission in Chapter 6A. Associated with this is setting an appropriate threshold; and the AER proposed using the same value as in transmission for capex reopeners and contingent projects, with the AER being able to vary the contingent project threshold values through the use of guidelines.

In respect of cost pass through events, the AER proposed a materiality threshold of one per cent of the ARR to apply to distribution.[387]

The AER also proposed that, where as a result of a cost pass through application the AER allows capex which is fully recovered during the regulatory period in which the relevant event occurs, the capex should not be rolled forward into the RAB at the next regulatory determination.

Timeframes for AER decision-making under the uncertainty regime

When the AER receives an application for cost pass throughs, contingency projects or capex reopeners, it has a set time to make its decision which varies according to the type of application.[388] The AER proposed for it to have more time to consider complex applications, which would involve an aligned timeframe set at 40 business days for normal applications with the ability to extend by an additional 60 business days for more complex or difficult applications.[389]

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385 MCE SCO, *Response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing*, 1 August 2007, pp. 29, 48.

386 AER, Rule change request, Part B, 29 September 2011, pp. 46-52.

387 Id., p. 50.

388 An exception to this is for negative pass throughs which have no set time limit.

389 AER, Rule change request, Part B, 29 September 2011, pp. 99-100.

11.1.2 Material errors

The NER allow the AER to revoke and substitute regulatory determinations where a material error arises. Depending on whether it is a distribution or transmission regulatory determination, there are different types of material errors which allow for revocation and substitution of regulatory determinations.

The AER was concerned that there may be the potential for a material error that would be outside the currently prescribed list for distribution regulatory determinations.[390] In transmission, uncertainty is created by the power to correct material errors caused by false or misleading information provided by the TNSP as there is no express limit placed on correcting such errors only to the extent necessary.[391] There may also be circumstances in which it may be more preferable or appropriate to amend a regulatory determination, as opposed to revoking and substituting the entire regulatory determination.[392]

The AER sought to remove these differences by broadening its ability to revoke and substitute for material errors in Chapter 6 of the NER. This would entail replacing the prescribed list of material errors in Chapter 6 with a more general reference to material errors or deficiencies, limiting changes related to false and misleading information under Chapter 6A "only to the extent necessary", expanding the circumstances for revoking and substituting regulatory determinations to address deficiencies under Chapter 6A, and being able to amend regulatory determinations in response to material errors.[393]

11.1.3 Shared assets

In this final rule determination, shared assets refer to assets used to provide both standard control services or prescribed transmission services and unregulated services. For distribution, the shared asset could be providing a combination of standard control services and unregulated services. For transmission, the shared asset could be providing both prescribed transmission services and unregulated services. This issue is likely to become more relevant in light of the potential for electricity network assets, such as poles and pits, to be used to provide access for the National Broadband Network (NBN).

The AER proposed shared assets cost adjustment mechanisms to allow consumers to benefit where distribution assets are used to provide non-standard control services, including alternative control services and unregulated services.[394] This could include

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390 Id., pp. 95-96.

391 Ibid.

392 Ibid.

393 False and misleading information is already limited in Chapter 6 in this way. "Deficiency" is already included in Chapter 6. For further information, see AER, Rule change request, Part B, 29 September 2011, p. 96.

394 AER, Rule change request, Part B, 29 September 2011, p. 60.

an ex ante forecast revenue adjustment to the ARR, or an ex post control mechanism adjustment such as reflecting the portion of revenue from the unregulated service.

11.1.4 Small scale incentive schemes

The AER proposed that it should have the power to develop incentive schemes outside of those already provided for in the NER.[395] It considered the rule change process for implementing new incentive schemes was cumbersome and over costly. The AER also proposed to amend Chapter 6A of the NER such that it would have discretion to decide whether or not to apply the existing incentive schemes to NSPs at the time of the regulatory determination.[396]

11.1.5 Chapter structure

The remainder of this chapter is structured as follows:

- section 11.2 summarises the Commission's position in the directions paper and draft rule determination;
- section 11.3 summarises the submissions received in response to the Commission's draft rule determination;
- section 11.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- section 11.5 provides guidance on the final rule.

11.2 Directions paper and draft rule determination

11.2.1 Uncertainty regime

Need for capex reopeners and contingent projects in distribution

In the directions paper, the Commission decided to include contingent projects and capex reopener mechanisms for distribution. This would better harmonise transmission and distribution, as well as making the NSP more accountable rather than relying on cost pass through applications for uncertain circumstances. A range of reasons were given for why the TNSP and DNSP face similar levels of uncertainty. Unlike competitive businesses, which are better able to adjust their behaviour in response to uncontrollable factors, the TNSP and DNSP are both generally obliged to continue to supply services even where their equipment is exposed to significant risks. In the absence of an uncertainty regime, the added risk for a regulated business would be factored into the cost of capital, forcing it up. A regulated business might also have

395 Id., pp. 56-58.

396 Id., p. 57.

more of an incentive to increase the forecast of capex or opex in its regulatory proposal to factor in circumstances which it cannot predict.

In the draft rule determination, the Commission elaborated further on its position in the directions paper. The Commission's starting point was that Chapters 6 and 6A of the NER should be consistent unless there are substantive reasons for a difference. The Commission accepted that there are certain disadvantages of an expanded uncertainty regime. It could dampen the incentive effects of an ex ante allowance in certain circumstances. It could also create administrative burden for the AER and stakeholders in responding to "mini-determinations" during the regulatory period. On balance, however, the Commission decided to maintain its position from the directions paper.

By setting the thresholds for these mechanisms at the correct level, as further discussed below, only the largest projects or events, which could be expected to have longer lead times, would be captured. Accordingly the administrative burden on stakeholders would be limited. In addition, experience with the uncertainty regime in Chapter 6A indicates that the incentive effects of the ex ante allowance provided under the regulatory determination process would not be substantially weakened.[397]

In respect of whether pass throughs provide sufficient protection, capex reopeners are intended to fulfil a different function by extending protection to very large events which are more difficult to predict and are more difficult to fully provide for as cost pass through events. Contingent projects, on the other hand, apply to a matter which is more specific to a particular business and more likely to occur than a cost pass through.

Stakeholders had previously expressed concerns with expanding the uncertainty regime for distribution. These related to the potential increase in intra-period determinations, administrative burden placed on parties to participate in each application, and weakening the expenditure discipline and price/revenue cap regime.[398] Some suggested that a NSP should be using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the uncertainty regime mechanisms.[399] In general, the Commission would expect a NSP to act in this way in respect of smaller projects. The threshold for capex reopeners and contingent projects means that these can only be used for larger projects. For such projects, it will be more difficult for the NSP to accommodate these within the existing allowance.

NSPs also suggested that the current uncertainty regime for transmission is not effective.[400] However, the Commission was of the view that it would be outside the scope of this rule making process to review the effectiveness of the uncertainty regime

397 It is noted that under Chapter 6A, these mechanisms have not so far created a significant burden, given that the contingent project mechanism has been used twice while capex reopeners have never been used.

398 Ethnic Communities' Council of NSW, Directions Paper submission, 16 April 2012, p. 3; EUAA, Directions Paper submission, 16 April 2012, pp. 24, 26.

399 MEU, Directions Paper submission, 17 April 2012, pp. 47-48, 60.

400 ENA, Directions Paper submission, 16 April 2012, pp. 27-28, 34-35.

for transmission. Issues specifically associated with the effectiveness of the cost pass through regime have been addressed as part of another rule change process.

Threshold for capex reopener and contingent project applications in distribution

For contingent projects, the AER proposed a threshold of $10 million which it considered was consistent with the AEMC's original intention in 2006 to align this with the regulatory test threshold.[401] In the draft rule determination, the Commission noted that there were mixed responses from DNSPs suggesting either the contingent project threshold was too low or too high.[402] The Commission maintained its position from 2006 and considered that the threshold should be aligned to the regulatory test threshold ie the Regulatory Investment Test for Transmission (RIT-T) and the proposed Regulatory Investment Test for Distribution (RIT-D). For this reason, guidelines were considered unnecessary to vary the contingent project threshold or for the contingent project threshold to be indexed by inflation.[403] Instead, the contingent project threshold would be directly linked to the estimated capital cost of the most expensive option to address the identified need under the RIT-T, as varied, for transmission and the proposed RIT-D, as varied, for distribution.[404]

Materiality threshold for cost pass through applications in distribution

The AEMC considered in 2006 the materiality threshold for cost pass through applications in transmission as important to promote stability and predictability of the revenue cap regime for both the regulator and the NSP.[405] Without such a threshold, it was considered that this would lead to greater uncertainty and an increase in administrative costs for the AER to determine a material event.[406] Hence, it was determined that the threshold should be one per cent of the MAR for transmission.

In response to the AER's rule change request, some DNSPs proposed that the materiality threshold for distribution should not be set as a value in the NER.[407] Instead, they considered that it should remain flexible to capture all non-trivial matters and reflect less lumpy capex in distribution.[408] Otherwise, the DNSP would be exposed to unrecoverable risks.[409] However, in the draft rule determination, the Commission was of the view that such an approach would introduce an undesirable

401 The regulatory test threshold in transmission has now been superseded by the RIT-T.

402 Ausgrid, Directions Paper submission, 16 April 2012, p. 7; SP AusNet, Directions Paper submission, 16 April 2012, p. 5.

403 Victorian DPI, Consultation Paper submission, 8 December 2011, pp. 5, 8.

404 In distribution, this value is equivalent to the estimated capital cost to the NSP affected by the RIT-D project of the most expensive potential credible option to address the identified need of $5 million. In transmission, this value is equivalent to the estimated capital cost of the most expensive option to address the identified need which is technically and economically feasible of $5 million.

405 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 106.

406 Ibid.

407 Ausgrid, Consultation Paper submission, 8 December 2011, pp. 30-32.

408 Ibid.

409 Ibid.

degree of subjectivity into cost pass through determinations, and give the DNSPs too much of an avenue to submit applications, which may or may not be trivial in nature. On balance, the Commission considered that a materiality threshold needed to be specified to provide for greater certainty to both the regulator and the DNSP.

The Commission understood that the AER applied the one per cent threshold in practice for distribution, even though it is prescribed only for transmission. Therefore, there should not be a significant impact on DNSPs in codifying existing AER practices, and no reason for a difference between transmission and distribution. This would provide for consistency, transparency, predictability and certainty on when the AER would be required to consider cost pass through applications.

Double recovery of capex arising from cost pass through applications

In its rule change request, the AER raised the issue that there would be a potential double recovery of capital costs through both cost pass through applications and including that incurred capex again when establishing the roll-forward RAB for the next regulatory period. In the directions paper and draft rule determination, the Commission supported this proposal to avoid the potential unintended double counting. This would be done by excluding the capital costs recovered through approved cost pass through applications during the current regulatory period from the calculation of the roll-forward RAB for the next regulatory period.

Timeframes for AER decision-making under the uncertainty regime

In the directions paper, the Commission considered extending the timeframe for decision-making on cost pass throughs and capex reopeners, but not in respect of contingent projects. In the draft rule determination, this was extended to contingent projects, given the AER's new evidence of the detail and complexity that may be involved in the AER's assessment of contingent project applications.[410]

In the directions paper, the Commission also considered a number of options relating to the circumstances in which the AER may extend its decision-making time and the extent of time required. In developing a position in the draft rule determination, the Commission considered that sufficient certainty and finality must be taken into account. To a certain extent, the need for fixing the timeframe would promote certainty and finality; however, it would not necessarily allow the NSP the ability to recover efficient costs for unforeseen events if there is a substantial delay that is outside of the NSP's control. For this reason, the Commission supported the AER's suggested principle in the draft rule determination that the "stop the clock" mechanism should apply in those circumstances which are outside of the AER or NSP's control. Such circumstances would be where the AER is waiting on the provision of information by a governmental authority, or is waiting on a judicial body or royal commission to make relevant information publicly available.

With respect to the time taken for the AER to wait on additional information from the NSP, the default decision-making time of 40 business days would be subject to the later

410 AER, Directions Paper submission, 2 May 2012, pp. 75-76.

of the date that the AER receives the NSP's information or any additional information associated with the NSP's written application. This requirement for the NSP to provide the AER with additional information the AER requires to make a determination under the uncertainty regime is currently unique for negative cost pass throughs, and extended to positive cost pass throughs, capex reopeners and contingent projects in the draft rule determination. This way, it was unnecessary to apply an extended decision-making timeframe to circumstances where the AER is waiting for additional information from the NSP.

Where the issues being considered are complex or difficult, but the AER has all the information that it needs, then the AER should be able to determine the issues within a set timeframe, albeit perhaps an extended timeframe. The Commission considered that the AER's proposal for an extended timeframe in these circumstances would provide the appropriate balance between giving the AER flexibility and offering some degree of finality and certainty in relation to the making of a decision by the AER. For these purposes, the draft rule adopted similar wording to that in section 107 of the NEL, which described the relevant issues as being of sufficient complexity or difficulty to warrant an extension of time.

In the directions paper, the Commission proposed an option to introduce a notification step where the NSP would be required to notify the AER if it was aware that there may be external events that could have an impact on the application before it makes its application. However, given the flexibility that would be built into the timeframe, such a notification appeared to be unnecessary in the draft rule determination. Nevertheless, the Commission encouraged NSPs to notify the AER in advance of its application if it becomes aware of matters that could potentially delay the AER in making its decision, which would assist in allowing the application to be processed more efficiently.

In the directions paper, the Commission also considered the NSPs' proposal for the AER to issue a draft of its decision where there are complex circumstances.[411] However, to the extent the complex circumstances or any lack of information preclude the AER from forming a view, there did not seem to be any value in requiring the AER to make a draft decision at that stage. The Commission considered that it would be difficult to expect the AER to prepare a draft decision in these circumstances and decided not to prescribe such a requirement. Nevertheless, the AER may also wish to seek to informally consult in the course of considering such matters.

11.2.2 Material errors

Scope for material errors

In the directions paper, the Commission sought supporting evidence to justify the AER's proposal to broaden the scope for material errors under Chapter 6. There was a lack of evidence noted in the directions paper and draft rule determination to support the view that the AER's current powers constrained its ability to revoke and substitute a regulatory determination for material errors.

411 ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 196-197.

NSPs also stated that there may have been opportunities for a material error to be corrected in a draft regulatory determination, but the AER has not always utilised its discretion to address the material error.[412] The AER itself observed that the circumstances justifying correction of a material error would be exceptional.[413] On this basis, the Commission decided in the draft rule determination that after the final regulatory determination is made, the regulatory determination should only be able to be changed as a result of merits review outcomes or in very clear and exceptional circumstances. Therefore, the Commission favoured keeping the scope of the material error provisions under Chapter 6 narrow and focussed on "computational" errors by the AER or situations where the AER has received false or misleading information. Provisions such as pass throughs, capex reopeners and contingent projects were considered the appropriate means by which more substantive changes to the regulatory determination should be made.

Expanding on its previous position in 2006, the Commission considered in the draft rule determination that in addition to providing certainty, transparency and maintaining the incentives built into the framework, the finality of the regulatory determinations must be preserved. For finality in a regulatory determination, the AER proposed limiting the timeframe for correcting material errors to six months following the making of the final regulatory determination, which would balance off the AER's proposed expansion of the scope of material errors.[414] Given the Commission's decision to maintain a narrow scope for material errors under Chapter 6, this proposed time limitation for addressing material errors was considered unnecessary.

Consistent with this position, the Commission considered in the draft rule determination that the Chapter 6 provisions provided more certainty and finality in the framework than the equivalent provisions under Chapter 6A, and there should be no reason for differences between Chapters 6A and 6 with respect to these types of material errors as these only relate to computational errors or situations where the NSP has submitted false or misleading information. Therefore, the Commission decided to narrow down the broader Chapter 6A provisions with the narrower Chapter 6 provisions. This also included limiting material errors in regulatory determinations caused by false or misleading information by reference to "to the extent necessary", which is currently the case for distribution regulatory determinations, but not for transmission revenue determinations.

The Commission also noted that an alternative approach to promote certainty and finality in the final regulatory determination could be to not permit it to be revoked and substituted for material errors, as currently has been the approach of the regulator Ofgem in the Great Britain. However, the Commission considered that the limited approach in Australia is appropriate.

412 ENA, Directions Paper submission, 16 April 2012, pp. 78-79; Jemena, Directions Paper submission, 16 April 2012, pp. 57-58.

413 AER, Directions Paper submission, 2 May 2012, p. 74.

414 Ibid.

Amending material errors

The AER proposed that it should be able to amend, as an alternative to revoking and substituting, a regulatory determination as a result of a material error or deficiency where it is more preferable or appropriate to do so. In the directions paper, the Commission considered that the power to amend regulatory determinations would impact on the NSP's ability to have any such amendments reviewed in a merits review, as noted in some submissions.[415] In the draft rule determination, the Commission maintained its view that the provisions relating to material errors should not be changed to include a power for the AER to amend a determination as a result of a material error.

11.2.3 Shared assets

General position

In the directions paper and draft rule determination, the Commission considered that customers who pay for one type of regulated service that is provided by a shared asset should not be paying for the full cost of the asset. Instead, those customers should be receiving some benefit from the asset being used for a service other than a regulated service. In the draft rule determination, the Commission elaborated further on the rationale for shared assets.

In the directions paper, the Commission noted that a shared assets cost adjustment mechanism could apply to transmission as well as distribution. In the draft rule determination, the Commission regarded this as consistent with the overall principle of harmonising Chapters 6 and 6A of the NER.

Cost allocation principles

With respect to a potential overlap between cost allocation principles and shared assets, the Commission noted in the draft rule determination that the cost allocation principles are limited as it would only allocate costs for future assets, as opposed to existing assets. This would create a problem when an asset that was used to provide a regulated service later becomes used to also provide an unregulated service or another regulated service. Under the cost allocation principles, as the costs have already been allocated to this asset, the mechanism cannot accommodate this change in circumstances, unless there has been a reclassification of service.

For these reasons stipulated in the draft rule determination, a shared assets cost adjustment mechanism would be available to the AER to apply to assets that provide both distribution or transmission services and any unregulated service. To avoid any doubt and potential overlap, the Commission stated that the AER's development of any shared assets cost adjustment mechanism must have regard to the cost allocation principles and the NSP's cost allocation method, and any incentives under the NER.

415 ENA, Directions Paper submission, 16 April 2012, pp. 78-79; Grid Australia, Directions Paper submission, 16 April 2012, p. 13.

Restrictions on the shared assets cost adjustment mechanism

As discussed in the directions paper, the AER proposed two shared assets cost adjustment mechanisms in the form of an ex ante revenue adjustment and an ex post control mechanism adjustment.[416] It stated that the control mechanism adjustment could be used for sharing a proportion of the pre-tax profits from the unregulated activities with the users of the regulated services.[417]

In the draft rule determination, the Commission did not consider it possible for a shared assets cost adjustment mechanism to share a portion of the profit or revenue from unregulated services. By transferring a portion of this profit or revenue to customers of regulated services, the mechanism would be limiting the revenue that the NSP could earn from the unregulated service. This would have the same effect as regulating the unregulated service, which does not appear to be permitted under the NEL and NER.

Shared assets cost adjustment mechanism – cost reduction

It was decided in the draft rule determination that the shared assets cost adjustment mechanism should operate in a way that would not be based on the profit or revenue received by the NSP from the unregulated service. The best way it was considered that this could work was if the sharing was implemented through a reduction in the costs of the shared asset that are recovered from consumers of the regulated service. That is, instead of recovering 100 per cent of the costs of the shared asset from consumers of the regulated service, a lower proportion would be recovered. A number of principles would be taken into account by the AER in determining this proportion, discussed further below, one of which could be having regard to the manner in which costs have been recovered or revenues reduced by the NSP in the past for a shared asset associated with the unregulated service. However, the shared assets cost adjustment mechanism would not apportion part of the revenue or profit from the unregulated service.

Sharing the benefit resulting from the asset being used to provide an unregulated service, as well as a regulated service, via a reduction in the costs recovered from the consumers of the regulated service, rather than by passing through a portion of the revenue or profits received from the unregulated service, means that there will be a limit on the amount of benefit sharing that is possible. For example, if the costs of the shared assets that are recovered from standard control service customers each year are $1 million in the absence of any sharing, but revenue from the unregulated use is $3 million per year, the maximum benefit that could accrue to standard control service customers would be $1 million per year.

Where the shared assets cost adjustment mechanism takes the form of a reduction in costs apportioned to consumers of the regulated services, a control mechanism adjustment including annual pricing adjustments would not appear to be appropriate.

416 AER, Rule change request, Part B, 29 September 2011, p. 60.

417 Id., p. 61.

A control mechanism adjustment would only be appropriate if the adjustment was linked to an external factor, such as the amount of profit or revenue received under a contract with a third party, and this could be converted into a price or revenue adjustment in the control mechanism in a "mechanistic" way without the AER having to make a subsequent decision. Such an approach would be administratively inefficient, given that the AER would be required to annually make these adjustments, and would create too much uncertainty for the NSP.

Instead of an adjustment to the control mechanism, the reduction in the costs allocated to consumers of the regulated services would feed through the building block determination into the ARR. This reduction would be determined by the AER at a regulatory determination according to guidelines based on the principles set out below. It should reflect the part of the costs of the relevant asset which are being recovered through charging for the provision of the unregulated service. By reducing the ARR for the NSP, the amount recovered from consumers will also be reduced. By including the decision in a regulatory determination, the cost reduction will be fixed for the regulatory period covered by that determination, which provides certainty for the NSP. In addition, this decision would be subject to the scrutiny that comes from consultation as part of the regulatory determination process and any subsequent merits review.

Timing

In the draft rule determination, the Commission was of the view that the cost reduction would only be implemented at a regulatory determination, regardless of when the sharing arrangement actually commences. This means that the NSP would be required to disclose information on its shared assets as part of its regulatory proposal to the AER. It would be possible for the reduction to occur in respect of a sharing arrangement which had not yet commenced, provided it was known with enough certainty at the time of the regulatory determination. If it was not known with enough certainty then the reduction could not apply until the next regulatory determination, even if the sharing arrangement commenced prior to that determination. There would be no reconciliation or "ex post adjustment" in respect of any sharing arrangement that was put in place during the middle of a regulatory period; the cost reduction would only start from the beginning of the next regulatory period. However, the historical use or revenue of the asset could be used as a factor to forecast future sharing of such an asset. Overall, this should provide the NSP who has a sharing arrangement some certainty as to what cost reduction could be expected. The proposed shared assets cost adjustment mechanism could also take into account Jemena's previous proposal for an exemption period to be given to newly shared assets for a period of several years.[418]

In respect of an ex post adjustment, or "true up", once the actual benefits in a period of a sharing arrangement are known, the Commission considered in the draft rule

418 Jemena, Consultation Paper submission, 8 December 2011, p. 107; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

determination that this should not be necessary.[419] First, if the sharing arrangements are set on the basis of a contract the revenue received should be relatively easy to predict. Second, the revenue received will be only one factor to consider in setting the cost reduction for consumers, which must be based on the cost of assets shared. Third, to the extent revenues received through the sharing arrangements change, the cost reduction can be adjusted at the next regulatory determination for the next regulatory period.

Jurisdictional arrangements

As referred to in the AER's original proposal, the Commission recognised in the draft rule determination that shared assets cost adjustment mechanisms currently exist under jurisdictional arrangements.[420] The approach that has been previously used in Queensland has been grandfathered in NER clause 11.16.3. This grandfathering extends until the next Queensland distribution determination in 2015. Since the mechanism applied is a forecast revenue adjustment made to the building blocks, this could be accommodated under the proposed rules. In South Australia, a profit sharing mechanism has been used, with a portion of the profits from unregulated activities passed onto regulated service users of the shared asset.[421] As described above, such a mechanism would not seem to be permitted under the general NEL and NER provisions.

Shared assets providing alternative control services

As noted in the draft rule determination in respect of distribution, the above approach would only address the situation where one use of the asset is to provide standard control services and another use is to provide an unregulated service. The AER also pointed out that there may be the circumstance where the asset is used to provide both alternative control services and unregulated services.[422] The Commission accepted that alternative control service customers of a shared asset should be paying costs reflective of its use for the provision of alternative control services, and agreed with the AER that there should be no reason why standard control service customers benefit from the use of a shared asset to provide unregulated services, while alternative control service customers do not.

Nevertheless, some submissions on the directions paper stated that the AER's proposal would result in customers of alternative control services being over-compensated through a revenue decrement as well as a separate control mechanism, and that alternative control services should be excluded.[423] The Commission considered in the

419 AER, Rule change request, Part B, 29 September 2011, p. 61; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

420 AER, Rule change request, Part B, 29 September 2011, p. 59.

421 Ibid.

422 AER, Directions Paper submission, 2 May 2012, pp. 34-35.

423 Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 35; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

draft rule determination that the AER has considerable discretion in setting the control mechanism for alternative control services under NER clauses 6.2.5(a)-(b) and 6.2.6(b)-(c) and so may impose requirements that only permit the NSP to recover such costs associated with the provision of alternative control services as are appropriately allocated to those services. Therefore, in respect of distribution, the shared assets cost adjustment mechanism would only deal with the circumstance where the asset is used to provide a standard control service.

However, the Commission considered in the draft rule determination that, where one use of the asset is for standard control services and the other use is for alternative control services, the standard cost adjustment described above should still apply for the costs recovered from the standard control service customers.

Guidelines and principles

Bearing in mind the shared assets cost adjustment mechanism described above, the Commission considered in the directions paper and draft rule determination that to facilitate NSPs seeking out and entering into sharing arrangements of the kind discussed here, NSPs would need some certainty about how the AER would determine the cost adjustment appropriate for a particular sharing arrangement.

Part of this certainty would be provided by principles guiding the AER's determination, and which would be set out in the NER. NSPs previously raised a number of principles that could be applied in this regard.[424] In setting these principles, consistent with the NEO, the Commission took the view in the draft rule determination that the approach to a shared assets cost adjustment mechanism should:

- provide clarity and certainty on how the AER would approach sharing the costs;
- provide cost reflective prices to consumers;
- promote innovation in NSP investments; and
- be able to be implemented in practice.

On this basis, the principles listed in the draft rule determination to which the AER must have regard to were:

- the NSP should be encouraged to use assets that provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of standard control services;

424 Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ENA, Consultation Paper submission, 8 December 2011, pp. 38-39; ENA, Directions Paper submission, 16 April 2012, pp. 36-37; Energex, Directions Paper submission, 16 April 2012, pp. 2-3; Ergon Energy, Consultation Paper submission, 8 December 2011, p. 14; ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 23, 97-98; Jemena, Consultation Paper submission, 8 December 2011, pp. 107-109; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

- a shared assets cost adjustment should not be dependent on the NSP deriving a positive commercial outcome from the use of the asset other than for standard control services;
- a shared assets cost adjustment should be applied where the use of the asset other than for standard control services is material. This means the benefit of sharing the cost of the asset based on use should outweigh the administrative costs of implementing the shared asset cost adjustment mechanism;
- the manner in which costs have been recovered or revenues adjusted in respect of the relevant asset in the past and the reasons for adopting that manner of recovery or adjustment should be taken into account;
- a shared assets cost adjustment should be compatible with the cost allocation principles and cost allocation method; and
- a shared assets cost adjustment should be compatible with incentives that the NSP may have under the NER.

The Commission considered in the draft rule determination that the above principles promoted its objectives on what the shared assets cost adjustment mechanism should achieve.

With respect to determining the appropriate portion of costs for the purposes of a shared assets cost adjustment, the Commission considered in the draft rule determination the most obvious approach is for the AER to base this on the relative use of the asset for the provision of the different kind of services such as the technical use or physical use. Another possible way could include using the ratio between the proportion of revenue from the asset for standard control services and the proportion of revenue from the asset for other than for standard control services over the current regulatory period. However, this should not be taken as precluding the AER from considering other possible bases for sharing the costs of the asset.

The Commission did not accept in the draft rule determination the principle that the NSP should only have to pass on the benefit of a shared asset if it receives a net profit as a result, which was proposed by NSPs to recognise the associated risks of the NSP with sharing arrangements.[425] In general, the NSP should bear the risk so it takes this into account when deciding whether to enter a sharing arrangement, as the Commission considered the NSP to be the party best able to assess and manage this risk.

In addition, for added certainty, the draft rule required the AER to set out in guidelines what its approach would be for determining the appropriate cost reduction for sharing arrangements, having regard to the above principles. Such guidelines may, for example, set out a particular methodology which the AER intends to use.

425 Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ENA, Consultation Paper submission, 8 December 2011, pp. 38-39; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

In the directions paper, the Commission considered including a draft rule requiring the AER to specify the shared assets cost adjustment mechanism at the framework and approach paper stage. However, the Commission decided in the draft rule determination that this would not be required because the shared assets cost adjustment mechanism would be prescribed in the NER, with supporting guiding principles and guidelines. This meant the NSP would need to submit information on its shared assets to the AER in the regulatory proposal.

11.2.4 Small scale incentive schemes

In the directions paper the Commission considered that the AER should be allowed to develop small scale pilot or test incentive schemes within an environment that limits the sum of money at risk and the length of time of the scheme. It also proposed that it would be appropriate for the AER to have the discretion to determine whether or not incentive schemes should apply at the time of a regulatory determination in Chapter 6A of the NER, consistent with Chapter 6.

In the draft rule determination, the Commission maintained its position. It elaborated that the AER should have the ability to innovate in this way without having to go through the full rule making process, which may be overly burdensome. It would be good regulatory practice to test or pilot a scheme before full implementation as incentive schemes could otherwise be introduced that lead to unexpected and perhaps unwelcome outcomes as identified by Professor Littlechild.[426] A permanent scheme should, however, be subject to the rule making test given the potential impact of the scheme.

The extent of a small scale incentive scheme should be limited by the sum of money at stake, ie revenue at risk, and the period for which the scheme lasts. In addition the scheme should be subject to consultation with relevant NSPs and other stakeholders before being implemented.

The sum of money at stake should balance the need to be high enough to understand how the scheme would be likely to operate but not so high that there would be a significant impact on a NSP if the scheme did not operate as intended. The Commission considered that this balance would be met if the revenue at stake was one per cent of revenue for a regulatory year if the NSP agrees with this amount, or up to 0.5 per cent of revenue for a regulatory year if the NSP does not. The lower revenue at risk that can be placed on the scheme if the NSP does not agree to it was to reflect that the NSP would have no choice as to whether a scheme is applied to it and the scheme would not have been subject to the rule making process. The AER would also be able to undertake paper trials, ie a scheme in which no money is at risk, as part of its discretion. The limits described above were considered high enough such that the effectiveness of a scheme would be able to be determined.

In terms of a restriction on the period of a scheme, any scheme would last for a maximum of two regulatory periods. If the AER wished the scheme to continue after

426 Stephen Littlechild, Advice to the AEMC on Rule Changes, 11 February 2012, p. 19.

this point then it would need to apply for the scheme to be made permanent through the rule change process. This length of time should be long enough for the AER to make a decision on whether the scheme was effective and therefore whether it would be a permanent scheme in the NER.

In addition to these requirements, the Commission did not agree that the draft rule should require the AER to seek the agreement of the NSP before commencing the trial as this would simply give the NSP a right of veto. However, as noted above, the revenue that could be put at risk from the scheme would be lower if the NSP did not agree to the scheme. Restricting the scheme to only parts of a NSP's operations would also overly restrict the AER.

Consistent with the general approach in respect of the rule change, the AER would have to take into account certain factors when developing these schemes. The principles developed for capex sharing schemes were considered broadly appropriate here. These addressed key issues, such as the fact that a scheme should not penalise efficient NSPs. At the same time, the principles were broad so that they did not overly restrict the AER. These factors were also in line with those put forward by the AER for its proposed power to develop other incentive schemes.[427]

The Commission maintained that it would be appropriate to allow the AER to have discretion to determine whether incentive schemes should apply at the time of a regulatory determination in Chapter 6A of the NER, consistent with Chapter 6.

11.3 Submissions

11.3.1 Uncertainty regime

Capex reopeners

The AER supports the introduction of the capex reopener and contingent projects regime for distribution as it considers this to be an additional option and be low in implementation costs.[428] With respect to capex reopeners, some DNSPs also expressed their support for including this in distribution to deal with unforeseen events which require significant capex for providing reliability and security.[429]

Contingent projects

On the introduction of contingent projects in distribution, most DNSPs maintain their previous objections to its inclusion.[430] Alternatively, they consider if it is introduced in

427 AER, Rule change request, Part B, 29 September 2011, p. 57.

428 AER, Draft Rule Determination submission, 5 October 2012, p. 14.

429 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 27.

430 ENA, Draft Rule Determination submission, 4 October 2012, pp. 41-44; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 27-29; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 5.

distribution, then the AER should not be able to "micro-manage" their networks which would mean the AER should not be able to: have regard to whether the proposed expenditure should be included as a contingent project; and propose its own contingent projects by transferring expenditure as a contingent project.[431] Instead, the AER would be applying the capex criteria to determine whether it is satisfied with the forecast or otherwise substitute this with its own.[432]

Threshold for contingent projects

Notwithstanding the DNSPs' opposition to introducing contingent projects in distribution, they consider that if it was to be required, then the threshold should only apply to very large individual projects in the vicinity of $30 million or five per cent of the ARR.[433] They consider that this value corresponds to projects that are large in size, small in number, based on well-defined trigger events, and proportionate to the size and value of the network.[434] Further, they consider that it should be made clear that the regime only applies to capex for an individual project and not capex related to more than one identifiable project.[435]

On the other hand, the DNSPs do not consider it appropriate to link the distribution contingent project threshold to the RIT-D threshold because of their fundamental difference.[436] The RIT-D threshold assumes it would be desirable in principle for the test to be applied to all projects, but that it should be limited to keep administrative costs proportionate to the benefit.[437] In contrast, the threshold for contingent projects should identify projects that cannot be accommodated in a standard price cap regime with ex-ante forecasts.[438] On the other hand, the NSPs then suggest that linking the characteristics of transmission projects might make it convenient for transmission contingent projects to be linked to the higher threshold of the RIT-T.[439] The joint submission from SA Power Networks, CitiPower and Powercor clarified that they did not support the contingent projects regime, and its reference to a $5 million threshold in its previous submission was in the context of pointing out an inconsistency between the AER's proposed $10 million threshold for distribution contingent projects and its link to the RIT-D threshold of $5 million.[440]

431 ENA, Draft Rule Determination submission, 4 October 2012, pp. 41-44.

432 Ibid.

433 Ibid.

434 Ibid.

435 Ibid.

436 Ibid.

437 Ibid.

438 Ibid.

439 Ibid.

440 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 29.

Materiality threshold for cost pass through events

With respect to the materiality threshold for cost pass through applications in distribution, some DNSPs maintain that the threshold should be set to $1 million to provide for certainty, rather than at one per cent of the ARR.[441] However, NSPs consider that if the one per cent threshold were to apply then it should cover an annual culmination of multiple events with the total impact considered as part of the threshold, which would be based on the cash flow impact (ie actual costs incurred) as opposed to the revenue impact.[442] They consider this approach would be consistent with the RPP to allow NSPs a reasonable opportunity to recover at least their efficient costs.[443]

In contrast, the AER has shifted from its original proposal and considers that the materiality threshold may be too low and may capture immaterial applications.[444] It proposes that this threshold should be treated as one factor, but not the only condition to determine the materiality of an application.[445]

11.3.2 Material errors

In the absence of any evidence to demonstrate that the AER has been constrained under the current arrangements for material errors, NSPs do not support changing the current NER provisions under Chapters 6 and 6A, except for making minor amendments to clarify the provisions.[446]

11.3.3 Shared assets

In general, the NSPs and MEU support the shared assets cost adjustment mechanism.[447] However, NSPs consider that further drafting is required to clarify the Commission's intended design.[448] Otherwise, they consider that the Commission's approach to applying a revenue requirement adjustment cannot be achieved with respect to revenue received from shared assets.[449]

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441 Id., pp. 6-7, 26-27.

442 Ibid; ENA, Draft Rule Determination submission, 4 October 2012, pp. 44-46; Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

443 Ibid.

444 AER, Draft Rule Determination submission, 5 October 2012, pp. 14-15.

445 Ibid.

446 ENA, Draft Rule Determination submission, 4 October 2012, p. 73; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14-15.

447 ENA, Draft Rule Determination submission, 4 October 2012, pp. 46-49; Energex, Draft Rule Determination submission, 4 October 2012, p. 2; Ergon Energy, Draft Rule Determination submission, 7 October 2012, pp. 7-8; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 11-12; MEU, Draft Rule Determination submission, 4 October 2012, p. 28.

448 Ibid.

449 Ibid.

NSPs support the approach where revenue is shared between assets with the RAB then allocated according to the types of services used for that asset, as opposed to the capex at the point it enters the RAB.[450] NSPs also support the Commission's approach to allow assets to be shared between standard control or prescribed transmission services with unregulated services.[451] However, they consider that the types of services that could be covered under a shared asset arrangement should be extended so that an asset can be shared between: standard control and alternative control, negotiated and unregulated services in distribution; and prescribed transmission and negotiated or unregulated services in transmission.[452]

To effect the shared assets cost adjustment mechanism, NSPs propose the RAB would include any expenditure for an asset that may be used for standard control or prescribed transmission services.[453] This would result in a "gross figure based" RAB, which can then be subsequently allocated between services that share the asset.[454] This would also require a change to the cost allocation principles so that it refers to the allocation of assets rather than capex.[455]

Associated to this, NSPs consider that past capex that has already been shared should be accounted for under the shared assets cost adjustment mechanism.[456] However, they consider their proposed "gross figure based" RAB would resolve this issue, as opposed to a RAB with only part of the asset value included.[457] This may result in a potential double allocation of costs if the RAB had previously been treated as a "gross figure based" RAB, which can be resolved by specifying that the AER needs to ensure that efficient allocation of costs is made.[458]

NSPs support the first principle which places a positive incentive upon NSPs to identify additional services for assets that provide prescribed transmission or standard control services.[459] However, they do not agree that implementing a shared cost assets arrangement should be contingent on whether there is a positive commercial outcome from such sharing.[460] At a minimum, they consider that the NSP should expect on an ex ante basis to be left whole from allocating the assets, which would be inferred from the first principle and the NEO.[461]

450 Ibid.

451 Ibid.

452 Ibid.

453 Ibid.

454 Ibid.

455 Ibid.

456 Ibid.

457 Ibid.

458 Ibid.

459 Ibid.

460 Ibid.

461 Ibid.

Grid Australia considers that transmission assets can be solely constructed for providing negotiated or unregulated services, and there is no reason for these particular assets to be shared and included in the RAB.[462] They note that schedule 6A.2 already provides for the situation where that asset later provides prescribed transmission services and is subsequently included in the RAB.[463]

11.3.4 Small scale incentive schemes

NSPs broadly consider the draft rule determination strikes the right balance between allowing for regulatory innovation and retaining important distinctions between rule making and regulatory application.[464] Other stakeholders did not comment on this aspect of the draft rule determination.

11.4 Analysis

11.4.1 Uncertainty regime

Contingent projects

With respect to limiting contingent projects to capex for an individual project and not capex related to more than one identifiable project, the Commission considers it is unnecessary to specify this in the NER.[465] The NER provides that the contingent project needs to be assessed and the associated trigger event defined in the regulatory determination, which determines the scope of the contingent project.

Also, by setting the thresholds for these mechanisms at the correct level, as further discussed below, only the largest projects or events, which could be expected to have longer lead times, would be captured. Accordingly the perceived "micro management" of the process and administrative burden placed on stakeholders would be limited, without the need to consider changing the current design of the uncertainty regime.[466] In addition, experience with the uncertainty regime in Chapter 6A indicates that the incentive effects of the ex ante allowance provided under the regulatory determination process would not be substantially weakened. The Commission notes that under Chapter 6A, these mechanisms have not so far created a significant burden, given that the contingent project mechanism has only been triggered twice while capex reopeners have never been used. However, given the number of contingent projects proposed on an ex ante basis via the regulatory determination process, it may be considered to be currently a significant burden on the AER to assess these.

462 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 11-12.

463 Ibid.

464 ENA, Draft Rule Determination submission, 4 October 2012, p. 36.

465 Id., pp. 41-44.

466 Ibid.

Threshold for contingent projects

In considering the ENA's reasons for the inappropriateness of basing the distribution contingent project threshold on the RIT-D and proposing an alternative threshold of $30 million or five per cent of the ARR (whichever is greater), the Commission has reconsidered its past position.[467]

In 2006, the AEMC considered that the relationship between the contingent project threshold for transmission and the regulatory test threshold had the advantage that it would be the same amount necessary for the application of the regulatory test to new augmentation investment.[468] Part of this was also based on information supplied by the Electricity Transmission Network Owners Forum (ETNOF) (now Grid Australia) and considering a number of indicative costs for potential contingent projects.[469]

In the draft rule determination, the Commission noted that the regulatory test threshold referred to in the 2006 determination had been replaced with the RIT-T, but the contingent project threshold had not been adjusted in the NER to reflect this change. On this basis, the Commission considered that the threshold should have been lowered to $5 million to reflect its original intention ie from $10 million to $5 million. Conveniently, this contingent project threshold for transmission would have then been the same as in the proposed approach for distribution as they would be both linked to their respective RIT-T and RIT-D thresholds which have the same monetary value.

On the NSPs' point that the distribution contingent project should be set at a level equivalent to the characteristics of transmission contingent projects, the Commission does not accept that the monetary threshold should be different.[470] This would imply that projects in distribution are generally larger than those in transmission, which is questionable. Instead, the thresholds should be at the same level. On this basis, to determine an appropriate threshold, the anticipated value of projects accepted by the AER in recent transmission regulatory determinations was examined. These are shown in Appendix B.

As can be seen in Appendix B, for ElectraNet and Transend, half of their current contingent projects would have not fallen under the NSPs' proposed $30 million contingent project threshold. However, Powerlink and TransGrid would not have been affected. In addition, if the threshold is the greater of $30 million and five per cent of the ARR or MAR, increasing one boundary of the threshold to $30 million will mean for some NSPs that this value will become greater than their five per cent of the ARR or MAR, and therefore their threshold will be based on a higher value of $30 million. This demonstrates that under the NSPs' proposal, the number of contingent projects to be proposed, assessed and defined, and volume of applications submitted to the AER (if they had been triggered) would be reduced. Further, the fact that only two contingent projects have been triggered to date (noting the Powerlink regulatory period has only

467 Ibid.

468 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 59.

469 Id., pp. 58-59.

470 ENA, Draft Rule Determination submission, 4 October 2012, pp. 41-44.

commenced mid 2012) may suggest that very uncertain projects are being proposed as contingent projects. Therefore, the administrative burden placed on the AER to consider a number of contingent projects during the regulatory determination process would be reduced by applying a higher monetary threshold for contingent projects. This issue becomes more evident if the AER considers multiple applications from different NSPs concurrently.

NSPs have suggested that the reason for the small number of triggered contingent projects is because the AER has taken a narrow interpretation of the trigger event and not defined it properly.[471] In the end, this is a matter for the AER.

For the above reasons, the Commission has decided that the contingent project threshold will be the greater of $30 million or five per of the ARR or MAR for both distribution and transmission. Future projects with a monetary value of between $10 million and $30 million will have to be assessed by the AER as part of the revenue allowance under the regulatory determination. This means that there is an appropriate balance between providing sufficient scrutiny of adequately large projects under the contingent project regime and other projects under the regulatory determination, and a reduction in the administrative burden placed on the AER and NSPs.

In fixing the threshold to the greater of $30 million or five per of the ARR or MAR, guidelines for varying the threshold and indexation of the threshold may be relevant considerations.[472] However, for reasons of certainty and administrative simplicity in applying the threshold, these options have not been pursued further. Further, changing the threshold value from the current arrangements can be considered as only a minimal change to design of the contingent projects regime as opposed to introducing indexation or a new guideline process.

Materiality threshold for cost pass through events

The Commission does not accept the NSPs' proposal for an annual accumulation of multiple cost pass through events to be considered when assessing the materiality of the cost pass through event application, nor setting the threshold to $1 million.[473] The Commission does not accept the AER's proposal to make it only one factor for consideration in assessing materiality.[474] On the one hand, the AER considers the threshold may be too low; while on the other, the NSPs consider it too high. This highlights the problem with not setting the materiality threshold as it creates divided views on its objective. As the AEMC stated in 2006, setting the materiality threshold to one per cent of the MAR is important to promote stability and predictability of the regime for both the regulator and the NSP.[475] In the absence of a specified materiality

471 Ibid.

472 Victorian DPI, Consultation Paper submission, 8 December 2011, pp. 30-32.

473 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 6-7, 26-27; ENA, Draft Rule Determination submission, 4 October 2012, pp. 44-46; Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

474 AER, Draft Rule Determination submission, 5 October 2012, pp. 14-15.

475 AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 106.

threshold, it would lead to greater uncertainty and an increase in administrative costs for the AER to determine a material event.[476]

Proceeding on the basis that the materiality threshold is set at one per cent of the ARR or MAR, the NSPs' proposed accumulation of multiple cost pass through events for a given year cannot be accepted. Firstly, the NSPs' proposal would dilute the effect of the materiality threshold. Secondly, the experience in transmission demonstrates that a non-cumulative materiality threshold can be applied without any problems. Finally, the approach reflects the AER's current practice in applying the materiality threshold for cost past through applications.

In terms of whether the costs associated with the materiality threshold are based on cash flow impact or revenue impact, that is a matter of detail for the AER to decide with respect to each particular application.[477] The Commission considers that it is sufficient to refer to the ARR as defined in the NER, without further elaborating on its existing definition.

For the above reasons, the materiality threshold for cost pass through events will be set at one per cent of the ARR for distribution.

11.4.2 Material errors

While the material error provisions have not been used extensively, the Commission considers that the provisions under Chapter 6 provide for more certainty and finality in the framework than the equivalent provisions under Chapter 6A. Further, there should be no reason for differences between Chapters 6A and 6 with respect to these types of material errors as these only relate to computational errors or situations where false or misleading information has been submitted. Therefore, the broader Chapter 6A provisions should be narrowed down to be consistent with the Chapter 6 provisions. This also includes limiting material errors in regulatory determinations caused by false or misleading information by reference to "to the extent necessary", which is currently the case for distribution regulatory determinations, but not for transmission revenue determinations.

11.4.3 Shared assets

Services covered under the shared asset cost adjustment mechanism

In designing the shared asset cost adjustment mechanism, the Commission intends that costs that customers incur for a service should be cost reflective. The shared assets cost adjustment mechanism allows users of an asset to benefit where the asset is used for a different service.

476 Ibid.

477 SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 6-7, 26-27; ENA, Draft Rule Determination submission, 4 October 2012, pp. 44-46; Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

In the draft rule determination, reference was made to the shared asset cost adjustment mechanism applying where the other use of the asset is an alternative control service.[478] In fact, the nature of the other types of regulated services (including alternative control services and negotiated services) means that the possibility of sharing is less likely. If, for example, a standard control service asset is used for alternative control service purposes, it is more likely that the service as a whole would be reclassified, making a sharing arrangement unnecessary. For simplicity, it is preferable to restrict the shared assets cost adjustment mechanism to arrangements where one use of an asset is for a standard control service or prescribed transmission service and the other use is for an unregulated service. Also, this would reduce the possibility of an overlap between the shared assets cost adjustment mechanism and the cost allocation principles which would have resulted in a double recovery.

Some submissions in response to the draft rule determination sought the inclusion of negotiated services within the shared assets cost adjustment mechanism. Given the flexibility in the way costs for negotiated services are recovered, the Commission does not see it as necessary for the shared assets cost adjustment mechanism to extend to negotiated services. A similar comment was made in respect of alternative control services in the draft rule determination.[479]

Gross figure based RAB

The Commission has not altered the current way in which capex is allocated to the RAB based on only standard control services. To change it to become a "gross figure based" RAB as proposed by the NSPs would result in a significant change in the existing way in which cost allocation and ring fencing guidelines operate. To effect such a change would create too much uncertainty as to the setting of the RAB and result in a volatile RAB for each regulatory reset.

The purpose of the shared assets cost adjustment mechanism is to address the situation where an asset used for a standard control service or prescribed transmission service is subsequently shared with an unregulated service, and the AER then could apply a revenue adjustment without resorting to reallocating the initial RAB value. If at the point where the capex enters the RAB it has been recognised that the asset is being used for unregulated services, and only the standard control services portion is included in the RAB, then the shared assets cost adjustment mechanism should not need to apply. This is because the mechanism is based on the presumption that the asset has not been shared at that stage. This should clarify the treatment of past assets where part of the past capex has already been allocated to other unregulated services. In that scenario, the shared assets cost adjustment mechanism would not be needed. To reinforce this point, a principle has been included which requires the AER to have regard to the manner in which costs have been recovered or revenues reduced with respect to the asset in the past.

478 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 212.

479 Id., p. 211.

Positive commercial outcome

The Commission reiterates its position that, in general, the NSP should have to bear some risk in the sharing arrangements so it takes that risk into account when deciding whether to enter a sharing arrangement of an asset. The NSP will be in the best position to assess and manage this risk. The NSP needs to be prudent in making its investment decisions when going into sharing arrangements. A benefit that the NSP may receive in sharing the asset is the likely potential to substantially gain revenue from that arrangement; while the only benefit to the existing customer is a reduction in its costs. It is the NSP's decision to share the asset with the objective of making a profit, balanced against whether it is a prudent decision to enter into such an arrangement. Otherwise, there would be no disincentive for the NSP to share an asset irrespective of the risk as it would pass on the costs to customers if it makes a bad investment decision.

11.4.4 Small scale incentive schemes

The Commission notes that the majority of the issues raised by NSPs on small scale incentive schemes were also raised in relation to capex sharing schemes. In particular NSPs suggested that:

- the AER should be required to compensate NSPs for the expected liability under the scheme where a scheme is asymmetric; and
- NSPs should have certainty on applicable schemes at the framework and approach stage.[480]

These issues are considered in sections 9.4.1 and 9.4.2.

The Commission does not agree with SP AusNet that the AER and NSPs should be allowed to agree on a revenue at risk higher than currently provided for. Given that the schemes will not have been subject to the rule-making test, the revenue at risk is appropriate. This will provide protection to both consumers and NSPs.

11.5 Guidance on final rule

11.5.1 Uncertainty regime

Capex reopener and contingent projects in distribution

Generally, the uncertainty regime has been aligned in distribution with transmission. This means that the capex reopener, contingent project and cost pass through arrangements are broadly the same.

480 ENA, Draft Rule Determination submission, 4 October 2012, pp. 36-38.

Threshold for capex reopener and contingent project applications in distribution

For capex reopeners, the threshold for distribution is capex that exceeds five per cent of the value of the roll-forward RAB for the first year of the regulatory period. The same threshold applies to both transmission and distribution.

For contingent projects, the threshold for both distribution and transmission is the greater of $30 million or five per cent of the ARR or MAR, respectively. The same threshold applies to both transmission and distribution.

Materiality threshold for cost pass through applications in distribution

The materiality threshold for cost pass through applications in distribution is one per cent of the DNSP's ARR. This brings it into line with the threshold applied in transmission.

Other aspects of cost pass through applications

Under the existing rules, the roll-forward RAB for the next regulatory period must include all capital costs incurred in the current regulatory period. This may unintentionally include pass through amounts associated with capital costs which have already been approved under the cost pass through arrangements. For clarity, the final rule amends the NER to reflect the fact that cost pass through amounts that have already been recovered in a regulatory period cannot be recovered again in the roll-forward of the RAB for the next regulatory period.

For the reasons explained above, the timeframes for the AER to make a decision on applications related to cost pass throughs, contingent projects and capex reopeners have been aligned at 40 business days from the time the AER receives the application and any additional information it requires from the NSP. This timeframe will be able to be extended by up to a further 60 business days if the AER determines that there are issues of sufficient complexity or difficulty that warrant such an extension. Such issues may require the AER to seek expert advice or consult with interested parties on a particular matter.

If the decision needs to be delayed to wait for further information from a third party, then a "stop the clock mechanism" will be able to apply. Such a third party may be a governmental authority from which the AER has requested information or a judicial body or a royal commission that the AER anticipates will make publicly available information that is relevant to the NSP's application.

In the case of either a time limit extension or the application of the "stop the clock" mechanism, the AER will be required to notify the NSP of the extension or delay no later than 10 business days before the date that the AER would have to make its decision (ie no later than 30 business days from the time the AER receives the application) and also publish notice of this on its website. In addition, the AER may also apply the "stop the clock" mechanism after it had already extended the period, but the AER would still be required to notify the NSP no later than 10 business days before the expiration of the extended date (ie no later than 90 business days from the time the

AER receives the application). The AER will also be required to advise the NSP when the "stop the clock" mechanism has ceased to apply, in which case it must again publish a notice on its website to this effect.

Case scenario – example of the "stop the clock" mechanism and extending timeframe by 60 business days

- On 1 July 2013, the AER receives from a NSP in New South Wales an application for a positive cost pass through within 90 business days of the positive event occurring. The application relates to a bushfire.
- At the time of the application, the AER is informed by the NSP that there is a royal commission on the bushfire and the outcome of the decision by the royal commission may have an impact on whether the NSP can recover for that cost pass through and, if allowed, potentially also the amount that the NSP can recover. The royal commission decision will not occur until after the normal decision-making timeframe for the AER, ie more than 40 business days after the AER received the NSP's application and such additional information regarding the application as the AER requires from the NSP.
- On 15 July 2013, the AER notifies the NSP that in order to determine the NSP's application, it requires information that it anticipates will be made publicly available by the royal commission. This notification occurs no later than 10 business days before it would have had to make the decision. The AER also publishes a notice on its website stating that the clock has stopped.
- On 29 November 2013, the royal commission publishes its decision. As a result of this, the "stop the clock" mechanism ceases to apply. The AER would inform the NSP and publish a notice on its website stating that the clock has restarted. The Commission would also expect the AER to state in that notice the date on which the AER will make its decision. In this case, it will be 30 business days after 29 November 2013, which will be 15 January 2014, taking into account public holidays. This is because 10 business days have already elapsed between 15 July 2013 and the time the clock stopped.
- However if, upon reviewing the royal commission decision, the AER determines that it requires more time to address a complex question related to the application, the AER could extend the decision-making period by a maximum period of a further 60 business days. To do so, the AER would need to notify the NSP of its decision to extend by no later than 10 business days before it would otherwise have had to make its decision on 15 January 2014. Therefore, the AER would need to give its notice, with respect to extending the period by the maximum of 60 business days, no later than 31 December 2012. The AER would also need to publish notice of the extension on its website as soon as reasonably practicable. The maximum additional period for the AER to make its decision will then expire on 10

April 2014.

- Note: In the scenario above, the "stop the clock" mechanism could only be triggered by the royal commission. The "stop the clock" mechanism does not apply to considering complex or difficult questions on the matter, where the timeframe can only be extended by a maximum additional period of 60 business days.

Given the introduction of capex reopeners and contingent projects for distribution, the timeframes for the AER to decide on these applications have been aligned with those in transmission.

Another consequential change relates to the decision making timeframe for negative cost pass through applications. The Commission notes that there is currently no set decision-making timeframe for this type of application, although a timeframe exists on when the application needs to be made. Previously in the Chapter 6A rule determination, the AEMC noted that there are asymmetries between positive and negative pass through applications that justify a difference in their treatment. However, with respect to decision-making timeframes, there should be no difference as the AEMC in 2006 recognised for capex reopeners and contingent projects. The decision-making timeframe for negative pass through applications has therefore been aligned so that there is a "standard" 40 business day timeframe with an option to extend as with the other types of applications. In addition, the AER will expressly be required to notify all NSPs of the occurrence of a negative change event if that event is not notified by the NSP to the AER and the AER proposes to determine a pass through amount.

However, unlike for positive change events, if the AER fails to make a pass through determination in respect of a negative change event within the 40 business day time limit, then the AER will be taken to have determined a zero pass through amount, noting that this 40 business day period can still be extended to accommodate issues that are difficult, and that the "stop the clock" mechanism will still apply where the AER is waiting on information from a governmental authority, judicial body or royal commission. As noted above, the reason for the different treatment of a default decision for negative cost pass throughs compared to positive cost pass throughs is due to the asymmetries between positive and negative pass through applications.

11.5.2 Material errors

Aligning the Chapter 6A provisions with the Chapter 6 provisions with respect material errors means that the AER will now only be able to revoke and substitute a transmission revenue determination or amend a pricing methodology for the following kinds of material errors or deficiencies:

- a clerical mistake or an accidental slip or omission;
- a miscalculation or misdescription;

- a defect in form; or
- a deficiency resulting from the provision of false or materially misleading information to the AER.

As with Chapter 6, for Chapter 6A the substituted revenue determination or amended pricing methodology will only be able to be varied from the revoked revenue determination or existing pricing methodology to the extent necessary to correct the relevant material error or deficiency.

11.5.3 Shared assets

The following case study is provided in this section to explain how the shared assets cost adjustment mechanism could work.

Case scenario

- In year 2 of a regulatory period the NSP enters into a commercial agreement with NBN Co to allow NBN Co to use electricity poles currently used for standard control service purposes. The rate is $2,000 per pole per year. The NSP's costs are $500 per pole per year.
- Given that this occurs during a regulatory period, no shared assets cost adjustment mechanism is applied until the next regulatory determination.
- In its regulatory proposal for the next regulatory determination, the NSP provides details of the shared assets in accordance the AER's regulatory information instrument.
- During the regulatory determination process, the AER decides whether to apply the shared assets cost adjustment mechanism in respect of the NBN arrangements for the next regulatory period. In making this decision, the AER takes into account the guidelines on how to apply the shared assets cost adjustment mechanism and the principles on whether a shared assets cost adjustment mechanism should apply. Some considerations at this point could include the materiality of the shared asset.
- Next, the AER would need to decide on the reduction in the costs for the assets that should not be recovered from standard control customers based on the guidelines. However, it would not directly pass through any of the profits or revenue gained by the NSP as a result of providing NBN Co access to its asset. A possibility could be to base this decision on the number of customers who will benefit from the electricity poles being used to provide NBN services compared to the number of customers who receive standard control services through the use of those electricity poles. For the purposes of this exercise, it may be too difficult to determine the number of customers, but it may be easier to determine that there is an equal share in the technical and/or physical use of that pole for standard

control services and NBN services. It may decide the cost reduction should be on a pole by pole basis over the forthcoming regulatory period.

- Once the AER determines the appropriate reduction of costs for standard control service customers, the AER needs to incorporate this into its building block determination. This determination leads to adjustments being made to the ARR and therefore being reflected in pricing to customers in the annual pricing approval process. In this case, based on the asset being shared according to physical and/or technical use, which has been attributed at 50 per cent, the reduction in the ARR is $250 per pole per year. This reduction only starts to apply from the following regulatory period and there would be no cost reduction for the period in which the commercial agreement was first put in place.

11.5.4 Small scale incentive schemes

The final rule gives the AER a broad discretion as to the schemes it may design. The schemes are intended to provide for incentives not already covered by the existing incentive schemes in the NER and may cover matters not related to expenditure by NSPs. For example, the AER could design a scheme which provides rewards for NSPs which engage more effectively with consumers. The final rule provides broad discretion so that the AER can develop any type of scheme that contributes to the NEO.

The principles are consistent with those for capex sharing schemes and therefore the guidance for these principles in section 9.5.2 is also appropriate here. Similarly, as with capex sharing schemes the AER is to set out its likely approach to the application of a scheme to a particular NSP in the framework and approach paper for the NSP. The NSP can then set out in its regulatory proposal how it proposes the scheme should apply, including any proposed values. The AER is to then set out how the scheme will apply to the NSP in the draft and final regulatory determination for the NSP.

12 Electricity transitional arrangements

Summary

- This final rule determination provides for a number of significant changes to Chapters 6 and 6A of the NER and also requires the AER to develop a number of guidelines by 29 November 2013. At the same time that the AER is to develop the guidelines, seven NSPs are due to start their regulatory determination processes and another eight are due to commence theirs within 12 months of the last date by which the guidelines are to be finalised. Transitional rules are therefore required to:
  - enable the new rules and guidelines to be applied in the next round of determinations; and
  - minimise the resourcing burden that the guidelines development processes and transitional arrangements could otherwise place on stakeholders, whilst also allowing consultation with stakeholders.
- Having considered a range of options, the Commission has decided to:
  - exclude those NSPs that are due to commence their regulatory periods post 2016 from the transitional arrangements (Aurora, Powerlink, ElectraNet and Murraylink); and
  - apply different transitional arrangements to the remaining NSPs.
- The transitional arrangements to be applied to the remaining group of NSPs will result in all decisions made by the AER from May 2014 onward being carried out in accordance with the new Chapters 6 and 6A rules and guidelines. An overview of these arrangements is provided below.
- SP AusNet (transmission), which is due to commence its next regulatory period on 1 April 2014, will be subject to the old Chapter 6A rules for three years before moving to the new rules on 1 April 2017.
- ActewAGL, Ausgrid, Endeavour Energy, Essential Energy, TransGrid and Transend are all due to commence their next regulatory period on 1 July 2014. This group of NSPs will have their full determination processes delayed by 12 months and will be subject to the placeholder with true-up model. In short, this model requires the AER to:
  - conduct a high level review of a NSP’s placeholder revenue requirement and make a determination before the transitional year;
  - make a full determination during the transitional year for years 2-5 and the transitional year, in accordance with the new Chapter 6 and 6A rules; and
  - use a net present value (NPV) neutral true-up mechanism to account for any difference between the placeholder value and the transitional year revenue requirement established in the full determination.

- Directlink, which is due to commence its next regulatory period on 1 July 2014, will not have its determination process delayed but it will be subject to an 11 month determination process rather than the 15 month extended process.
- Energex, Ergon, SA Power Networks are due to commence their next regulatory period on 1 July 2015 while CitiPower, Jemena, Powercor, SP AusNet and United Energy are due to commence theirs on 1 January 2016. This group of DNSPs will have their determination processes delayed by five months and will be subject to the preliminary determination with mandatory re-opener model. At its most elementary, this model involves:
  - using the AER's draft determination as a placeholder for a NSP's revenue requirement and prices until the final determination is made; and
  - using an adjustment mechanism to account for any difference between the draft and final determinations in NPV neutral terms.

  From a legal perspective, a binding determination must be in place before the regulatory period commences. The draft determination is therefore referred to as a preliminary determination while the final determination, which revokes and replaces the preliminary determination, is referred to as the substitute determination. Although the terminology differs, the decision making and consultation process that occurs between the preliminary and substitute determinations are intended to be the same as what would occur between a draft and final determination.
- These transitional arrangements may be viewed as a continuum, with the time taken to transition to the new rules and the differences between the standard determination process and the transitional determination process diminishing over time.

12.1 Introduction

This final rule determination provides for a number of significant changes to be made to the rate of return, capex, opex, incentive scheme and regulatory process provisions in Chapters 6 and 6A of the NER. It also requires the AER to develop a number of guidelines by 29 November 2013, including:

- rate of return guidelines;
- capital expenditure incentive guidelines;
- expenditure forecast assessment guidelines;
- shared asset guidelines; and
- confidentiality guidelines.

These guidelines are intended to play an integral role under the new rules and the NSPs, the AER and the appeal body are expected to have significant regard to them as the starting point for each regulatory determination.

Over the same period that the AER is required to develop these guidelines, seven NSPs[481] are due to submit their regulatory proposals. Another eight NSPs[482] are due to submit their proposals within 12 months of the date by which the NER requires the guidelines to be finalised. Given the degree of overlap between the guideline development and regulatory determination processes, the Commission has given further consideration to the transitional arrangements that could be put in place to:

- enable the new rules and guidelines to be applied to NSPs in the next round of regulatory determinations;
- provide NSPs sufficient opportunity to take account of the new guidelines when preparing their regulatory proposals and allow sufficient time for stakeholder consultation;
- provide those NSPs that are subject to any transitional arrangements with a reasonable opportunity to recover at least their efficient costs; and
- minimise the resourcing burden that the guideline development and regulatory determination processes could otherwise place on the AER, NSPs and other stakeholders.

The remainder of this chapter is structured as follows:

- section 12.2 sets out the principles that the Commission considers should guide the development of transitional arrangements;
- section 12.3 provides an overview of the consultation process and the alternative transitional arrangements that were canvassed during this process;
- section 12.4 contains a summary of the submissions received;
- section 12.5 outlines how the first set of guidelines are to be developed;
- section 12.6 examines the need for transitional arrangements;
- section 12.7 identifies the NSPs that will be subject to the transitional arrangements and the period over which the transitional rules will operate;
- section 12.8 sets out the Commission’s final decision on the form that these arrangements should take;

481 The seven NSPs are: SP AusNet (transmission), TransGrid, Transend, ActewAGL, Endeavour Energy, Essential Energy and Ausgrid

482 The eight NSPs are: Ergon, Energex, SA Power, Jemena, United Energy, CitiPower, Powercor and SP AusNet (distribution).

- sections 12.9 to 12.12 provide further guidance on how the transitional rules are intended to be applied to those NSPs that will be subject to the arrangements; and

- section 12.13 contains a summary of the transitional arrangements that will apply to each NSP and the timetable for the next round of regulatory determinations.

12.2 Principles guiding the development of transitional arrangements

In its consultation paper, the Commission set out four principles that, in its view, represented the most important considerations in developing transitional arrangements. These principles are:

1. the final rules when made in November 2012 should apply to all service providers as soon as possible. This includes those service providers currently due to submit regulatory proposals in February and May 2013;

2. where any transitional arrangements are made regarding determination processes that require consultation, the arrangements should allow sufficient time for stakeholder consultation;

3. the transitional arrangements should provide service providers with a reasonable opportunity to recover at least the efficient costs they incur in the provision of regulated services; and

4. any transitional arrangements should be practicable having regard to the regulator's resourcing constraints, as well as the resourcing capacity of other stakeholders.

During the consultation process it became apparent that there was a fifth principle that the Commission should have regard to when developing transitional arrangements.[483] That is, any arrangements put in place to facilitate the transition to the new rules should minimise the potential for one-off price shocks.

For the reasons set out in sections 2.4-2.6, the Commission is of the opinion that these five principles are consistent with both the NEO and the RPP. The Commission has therefore borne these principles in mind when assessing the various proposals that have been made about the form that the electricity transitional arrangements should take.

483 During the consultation process, some stakeholders noted that if there was a one year determination followed by a full four or five year determination, there could be a significant change in prices between the transitional and full determinations because the AER would not be able to smooth price changes over the two determinations. This form of price volatility would be contrary to the long term interests of consumers, so the Commission has been cognisant of the desirability for the transitional rules not to give rise to one-off price shocks.

12.3 Consultation process and alternative models canvassed

On 14 September 2012, the AEMC published a consultation paper on the arrangements that could be applied to both gas and electricity service providers to facilitate the transition to the new rules. As part of this consultation paper, the Commission outlined the arrangements that could be put be put in place to:

- enable NSPs to transition to the new rules and guidelines in the next round of regulatory determinations; and
- minimise the resourcing burden that the guidelines development processes and the transitional arrangements could otherwise place on the AER, NSPs and other stakeholders.

In short, the proposal set out in the consultation paper provided for a 12 month delay to the commencement of the next full regulatory period for all NSPs except ElectraNet, Murraylink and Directlink. It also provided for the following determination processes:

- a limited scope determination process, which was to be carried out for the 12 month transitional period using a mixture of old and new rules; and
- a normal determination process, which was to be carried out for the delayed full regulatory period in accordance with the majority of the new rules and guidelines.

Within the consultation paper, the Commission encouraged stakeholders to suggest alternative approaches if they considered there were better arrangements to those outlined above.

To facilitate further discussion on this issue, the AEMC held a stakeholder workshop on 26 September 2012. During the workshop it became apparent that the AER and NSPs had a number of concerns with the arrangements proposed in the consultation paper. These concerns primarily related to:

- the potential for a one year limited scope determination to result in one-off price and revenue shocks; and
- the complexities, resource intensity and other inefficiencies associated with carrying out two full determination processes within two years.

A week and a half after the stakeholder workshop, TransGrid provided a submission to the AEMC, which set out an alternative model for the transitional arrangements.[484] In simple terms, the TransGrid model provides for a 12 month delay to the full determination process whilst also maintaining the current schedule of regulatory periods. It does so by allowing:

484 TransGrid, Consultation Paper on Savings and Transitional Arrangements submission, 8 October 2012.

- a placeholder value to be used for a NSP's revenue requirement in year 1, which is established through a high level regulatory review process conducted by the AER shortly before the commencement of that year;

- a full determination of the NSP's revenue requirements for years 1-5 to be carried out by the AER, in accordance with the new rules and guidelines, 12 months later than it would otherwise be required to do so; and

- any difference between the placeholder value and the year 1 revenue requirement established through the full determination process to be accounted for by the use of a net present value (NPV) neutral true-up mechanism.

TransGrid's proposal prompted further consultation between the AEMC, the AER, NSPs and consumer groups. It also resulted in the identification, including by the AEMC, of a number of other variants of the TransGrid placeholder with true-up model, including the mechanistic[485] and hybrid[486] placeholder models.

Another model that was identified by the AEMC during the consultation process was the preliminary determination with mandatory re-opener model. At its most elementary, this model involves:

- using the AER's draft determination as a placeholder for a NSP's revenue requirement and prices until the final determination is made; and

- using an adjustment mechanism to account for any difference between the draft and final determinations.

This model is referred to as the "preliminary determination with mandatory re-opener model" because, from a legal perspective, a binding (final) determination must be in place prior to the start of a regulatory period. The application of this model therefore requires:

- a final determination to be made in advance of the regulatory control period. In effect, what would have been the draft determination under a full determination process becomes the final determination. Because of its subsequent re-opening, this determination is referred to in the remainder of this chapter as the "preliminary determination"; and

- a mandatory re-opening of the preliminary determination and the substitution of this determination with a new determination by the AER. The new determination is, in effect, the final determination that would have arisen through the usual

485 The mechanistic model works in precisely the same way as the TransGrid model but rather than the AER reviewing the placeholder revenue, the transitional rules would require a NSP's placeholder revenue to fall below a cap specified in the rules.

486 This model, as its name suggests, is a hybrid of the mechanistic and TransGrid models. Under this model, a NSP's placeholder revenue could be either: below a cap specified in the transitional rules, in which case the proposed placeholder revenue is automatically accepted; or above a cap specified in the transitional rules, in which case the AER is required to conduct a high level assessment of the proposal.

determination process. This new determination is referred to in the remainder of this chapter as the "substitute determination".

There are a number of potential benefits of this model over the placeholder with true-up model, including:

- the process to be followed and the decisions that the AER is required to make are in all practical respects equivalent to those it would have to make under a standard regulatory determination process. This includes the consultation process between the preliminary and final determination, which is intended to be the same as that between a standard draft and final determinations;

- the true-up can be seen as analogous to that which is required between a final determination and the outcome of a merits review at the moment, so the concept of this type of true-up is familiar to stakeholders;

- the AER is required to carry out the detailed assessment set out in Chapters 6 and 6A of the NER rather than conducting a high level review of a placeholder value; and

- it avoids a number of measurement issues and rate of return related issues associated with the placeholder with true-up model because the preliminary determination is made before the commencement of the regulatory period and the substitute determination is made shortly thereafter.

A potential shortcoming of this model is, however, that the consultation period is two to three times longer than what would be required for the placeholder determination (six months vs two to three months). It may not therefore be possible to apply in all cases.

The preliminary determination with mandatory re-opener model also has a number of advantages over existing provisions within the NER such as clause 6.11.3(b). This clause states that if a period intervenes between the end of one regulatory control period and the commencement of a new determination, then the prior determination continues in force and appropriate adjustments can be made in the later determination. The advantages that the preliminary determination with mandatory re-opener model has over this clause are that it will:

- allow the new rules to come into effect earlier than clause 6.11.3(b);

- result in prices in the first regulatory year that are more likely to be closer to those established in the substitute determination than what would occur if prices were carried over from the prior determination;

- provide NSPs and other stakeholders with a greater degree of certainty about the rate of return that will apply over the regulatory period before the commencement of the period; and

- avoid a number of measurement issues and the need to have a regulatory determination applying for a partial year (ie 4.5 years).

The consultation period for the transitional rules formally ended on 26 October 2012 and 19 submissions were received. An overview of the views expressed in these submissions is provided in the following section.

Before moving on though, it is worth noting that the Commission is aware that the AER and NSPs have worked collaboratively throughout the consultation period to try and develop an alternative model that is both:

- consistent with the principles set out in section 12.2; and

- simpler to implement and less resource intensive than the model proposed in the consultation paper.

The Commission appreciates the efforts that have been made and values the work that has been done in a short period of time on this complex issue. The Commission would also like to extend its thanks to consumer groups, the AER and NSPs for making themselves available to discuss the transitional arrangements during the consultation period.

12.4 Submissions on consultation paper

Responses to the consultation paper and the proposed transitional arrangements for NSPs were received from the AER, those NSPs affected by the transitional arrangements, the ENA, QTC, the MEU, the Victorian DPI and the ESAA. The topics touched on in these responses can be broadly categorised as relating to:

- the need for transitional arrangements;

- the appropriate model to use for transitional arrangements;

- the operation of incentive schemes during the transitional year; and;

- a range of other ancillary issues.

The remainder of this section contains an overview of the views expressed by stakeholders on each of these topics.

12.4.1 Need for transitional arrangements

Most of the submissions received in response to the consultation paper acknowledge that some form of transitional arrangement is required.[487] However, the following

[487] See for example, AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 1; MEU, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, pp. 1-2; and SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p.1.

NSPs question whether the arrangements should be applied to them and, if so, the form the arrangements should take:

- SP AusNet (transmission) contends that the proximity of its next regulatory period with the guideline development process is too close and accordingly, it should be subject to the old Chapter 6A rules for 4.25 years.[488] A 4.25 year period would mean that SP AusNet would become subject to the new rules at the same time as ElectraNet;[489]
- ActewAGL submits that if it is subject to a 12 month delay then it will result in a direct overlap with its gas access arrangement review process and give rise to significant resource constraints.[490] In its initial submission, ActewAGL suggested it should be subject to the old Chapter 6 rules during the next regulatory period.[491] However, in later discussions ActewAGL has suggested that if its electricity regulatory process is to be delayed by 12 months then its gas access arrangement review should also be delayed by the same period;
- CitiPower, Powercor and United Energy prefer to maintain their existing timetables and not be subject to delay.[492] United Energy also questions why resourcing issues for the regulator are allowed to perpetuate for three years;[493] and
- Powerlink and Aurora question the need for transitional arrangements to be applied to them given their next regulatory periods are not due to commence until 2017.[494]

In a similar manner to the last two groups of NSPs, the MEU is of the view that transitional arrangements should only apply to those NSPs that are due to submit their regulatory proposals in 2013, ie SP AusNet (transmission), the NSW DNSPs, ActewAGL, TransGrid and Transend.[495]

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488 As an alternative, SP AusNet proposes that its revenue in the transitional year should be rolled over from the prior regulatory period with a CPI escalation and that no subsequent true-up should be carried out.

489 SP AusNet, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 2-5.

490 ActewAGL also noted the potential for a retail price review to be carried out in 2013-14.

491 ActewAGL, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

492 CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 1 and UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1.

493 UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1.

494 Aurora Energy, Consultation Paper on Savings and Transitional Arrangements submission, 29 October 2012, p. 2 and Powerlink, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 2.

495 MEU, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, pp. 1-2.

12.4.2 Model to be used for transitional arrangements

The transitional arrangements set out in the consultation paper did not receive any support from stakeholders.[496] Instead, stakeholders expressed a preference for a placeholder with true-up style model to be used if there was to be a 12 month delay to the full determination process. Different views have, however, been expressed about how the placeholder value should be established. These views can be summarised as follows:

- the AER does not support the use of either the mechanistic or hybrid models because it is concerned that a cap may act as a default position and result in placeholder values that do not reflect efficient costs. The AER is therefore of the view that some level of regulatory consideration of the placeholder value is required and has suggested that a modified version of the TransGrid model be adopted. The differences between the AER's and TransGrid's models principally relate to:
  - the information to be provided by NSPs to support their placeholder proposals, with the AER proposing the provision of more detailed information than TransGrid; and
  - the criteria to be applied by the AER when assessing a NSP's placeholder proposal, with the AER suggesting a number of additional criteria to those proposed by TransGrid.[497]
- TransGrid is of the view that the model it proposed should be used although it acknowledges that the hybrid model may also be appropriate;[498]
- the NSW DNSPs support the use of both the modified version of the TransGrid model proposed by the AER and the hybrid model;[499]

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496 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; Transend, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, p. 1; TransGrid, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; ActewAGL Distribution, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 3; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 1; NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 4; and MEU, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, pp. 1-2.

497 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 8.

498 TransGrid, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 1.

499 NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 4-7.

- the Queensland DNSPs, Transend and Jemena support the hybrid model,[500] SA Power Networks is indifferent between the mechanistic and hybrid models[501] and ActewAGL prefers a more mechanistic approach;[502] ;
- CitiPower and Powercor are of the view that NSPs should be able to choose either a mechanistic approach or a propose-consider model. The mechanistic approach proposed by CitiPower and Powercor differs, however, from the mechanistic model described in section 12.3;[503]
- SP AusNet (distribution) is of the view that the placeholder value for the Victorian DNSPs should be based on their first year revenue requirement, as set out it in their respective regulatory proposals;[504]
- United Energy submits that it should be able to set prices for the transitional year based on its own circumstances with the objective of minimising future price volatility;[505]
- the MEU prefers TransGrid's proposal but notes the potential for inaccuracy and inequity in the first year;[506] and
- the Victorian DPI is of the view that the placeholder revenue should be determined by rolling forward the approach to determining opex, or otherwise applying a total factor productivity based price path for the first year, or freezing the network charges in real terms with STPIS.[507]

Further detail on the views expressed by stakeholders about specific elements of the placeholder with true-up model is set out below.

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500 Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 1-2; Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 4; Jemena, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 1; and Transend, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, pp. 1-2.

501 SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

502 ActewAGL Distribution, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 1-3.

503 CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 3.

504 SP AusNet, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 8.

505 UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1.

506 MEU, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, p. 2.

507 Victorian DPI, Draft Rule Determination submission, 2 November 2012, p. 5.

True-up mechanism

The following comments were made by stakeholders about how the true-up should be carried out:

- most of the NSPs are of the view that any true-up that is undertaken should be carried out on a NPV neutral basis;[508] and
- the Victorian DNSPs are of the view that the true-up should only be carried out on the rate of return and that no true-up should be carried out for opex and capex.[509]

In further discussions with the AEMC, the AER and SA Power Networks suggested that the final year X factor anchor point (clauses 6.5.9(b)(2) and 6A.6.8(c)(2) of the NER) should be relaxed in the transitional rules so that any true-up that may be required over years 2-5 results in a smooth price path.

Potential for retrospective decisions on operating and capital expenditure

A number of NSPs have concerns about the potential for the AER to have regard to actual opex and capex data, rather than forecast data, when carrying out its full determination close to the end of the first year.[510]

The AER recognises the potential for this to occur under the placeholder with true-up model but is of the view that this matter can only be addressed if a more substantial process is carried out ahead of the first year, eg the consultation paper approach. The AER notes that, on balance, the industry appears to support the placeholder with true-up model and that most NSPs view the level of uncertainty around opex and capex as manageable, particularly if they are not penalised under an expenditure incentive sharing scheme.[511]

Rate of return related issues

The manner in which the rate of return should be measured under the placeholder with true-up model was referred to in a number of submissions.

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508 See for example, Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 6; NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, Attachment 1, p. 1; TransGrid, Consultation Paper on Savings and Transitional Arrangements submission, 8 October 2012; and SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

509 Jemena, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; and UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1.

510 See for example, NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 3 and Jemena, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 1-2.

511 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 9.

Although there appears to be broad consensus amongst interested parties that a single rate of return should apply across the period,[512]different views have been expressed about the period over which the rate of return should be measured, ie before the first year[513] or in the lead up to the second year. Notwithstanding the differences in opinion on this issue, NSPs and the AER appear to see benefits in the framework and approach process being used to:[514]

- identify any market observation period that may be required to measure the rate of return; and
- set out the AER's view on the methodologies that it is likely to accept for the measurement of the return on debt.

Having these matters resolved before the commencement of the first year was viewed by a number of NSPs as being of considerable importance given their financing arrangements.[515]

12.4.3 Operation of incentive schemes

The views of stakeholders on whether incentive schemes should operate for the first year vary depending on the incentive scheme, as set out below:

- *Capex sharing schemes and ex post capex review* – there is general consensus amongst NSPs and the AER that capex sharing schemes should *not* operate for the first year.[516] NSPs are also of the view that the AER should not be able to

512 See for example, QTC, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, p. 2; Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 5-6; UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1; and CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2,

513 See for example, Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 5; CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; and SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 4.

514 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 10, SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 3-4; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 5-6; UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1; and CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

515 See for example, Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 5 and SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 4.

516 See for example, AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 11; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; and NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, Attachment 1 p. 4.

preclude capex incurred during the current regulatory period from being included in the RAB as part of an ex post efficiency review.[517]

- *Efficiency Benefit Sharing Scheme (EBSS)* - there were mixed views on the EBSS with some NSPs suggesting that it be suspended[518] while other NSPs and the Victorian DPI thought it should operate.[519] The AER has indicated that there is some uncertainty as to the future form of the scheme and that its ongoing application will be considered concurrently with the development of guidelines in 2013. It suggests therefore that the framework and approach paper process be used to set out how the EBSS will apply for the first year. It also suggests that the transitional rules should provide flexibility for the EBSS to apply differently for the first year (eg by setting the target in the first year equal to actual operating expenditure).[520]
- *Service Target Performance Incentive Scheme (STPIS)* - there is broad support amongst stakeholders for the continuation of the STPIS (distribution and transmission).[521]
- *Demand Management and Embedded Generation Incentive Scheme (DMEGCIS)* – there is also broad support amongst stakeholders for the continuation of this scheme.[522]

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517 See for example: ActewAGL Distribution, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 3; ENA, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 3-4; ESAA, Consultation Paper on Savings and Transitional Arrangements submission, 23 October 2012, pp. 1-2; Jemena, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 2-3; and UE and MG, Consultation Paper on Savings and Transitional Arrangements, 26 October 2012, p. 2.

518 CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 4; SP AusNet, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 6; UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1; SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 4; and NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 3.

519 Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; TransGrid, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, Attachment 2 pp. 1-2; and Victorian DPI, Draft Rule Determination submission, 2 November 2012, p. 5.

520 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 10.

521 See for example, AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 11; SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 5; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 3; and TransGrid, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, Attachment 2.

522 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 11; SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 5; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; and NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 3.

- *Jurisdictional schemes* - stakeholders agreed that jurisdictional schemes such as the Victorian F-Factor scheme and the NSW D-factor scheme should continue to operate in the first year.[523]

12.4.4 Other ancillary issues

The implementation of both the placeholder with true-up model and the consultation paper model requires a number of ancillary decisions to be made for the first year. The views expressed by stakeholders about how these decisions should be made are summarised in the table below.

Table 12.1 Treatment of ancillary decisions in transitional year

Ancillary Decisions	Views of stakeholders
Additional pass through events	The AER, NSW DNSPs, Energex, Ergon, SA Power Networks, CitiPower and Powercor are of the view that these events should be carried over from the current regulatory period.
Negotiating framework	The AER, NSW DNSPs and SA Power Networks are of the view that these elements should be carried over from the current regulatory period.
Negotiated Distribution/ Transmission Service Criteria	
Pricing methodology for transmission	
Classification of distribution services	The AER suggests this be dealt with through the framework and approach paper process.
Form of control mechanism (including X factor) for standard control services and associated formulae	The AER, CitiPower, Powercor, NSW DNSPs and SA Power Networks suggest that this be dealt with through the framework and approach paper process.
Form of control mechanism for alternative control services and associated formulae	The NSW DNSPs suggest that this be dealt with through the framework and approach paper process.
Application of Part J of Chapter 6A to services provided by dual function assets	The AER suggests that this be dealt with through the framework and approach paper process.
Connection policy	The AER, NSW DNSPs and SA Power Networks note that this will need to be dealt with on a jurisdictional basis.
Prices of Alternative Control Services	In a number of submissions a distinction has been drawn between alternative control services that can be subject to a true-up (eg public lighting and metering services) and those that cannot (eg fee and quoted services). For those alternative control services that cannot be subject to a true-up, interested parties expressed the following views: • the AER suggests that prices from the prior regulatory period be rolled forward with a CPI adjustment; • CitiPower and Powercor are of the view that prices should be rolled forward at CPI+2% because most of these services are labour rate based and these costs tend to increase at a faster rate than CPI; • Energex suggests that prices may be rolled forward with a CPI adjustment, continue with the existing methodology or use the new rates proposed as part of a pricing proposal; and • Ergon suggests using a hybrid model, so that if the proposed price falls below a cap it is automatically approved but if it is above the cap the AER must review the proposed price.

Sources: AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 10-12; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2, Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 5; SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 3-5; CitiPower, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 2-4; and NSW DNSPs, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 3-4.

523 Id., p. 12; CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 2,4.

12.5 Guideline development process

In the draft rule determination and draft rules the Commission set out detailed timetables for the development of the various guidelines that the AER is required by the new rules to produce.

On reflection, the Commission is of the view that the AER should have some flexibility to manage its work programme and determine the dates by which key milestones will be achieved in respect of the guidelines. The transitional rules therefore only require the first version of these guidelines to be finalised by 29 November 2013.

To provide NSPs and other stakeholders with sufficient notice and certainty upfront, the transitional rules also require the AER to publish a statement by 21 December 2012 that sets out:

- a proposed schedule, including milestones and key dates, for the making of the various guidelines; and
- the specific consultation procedure to be followed, which must at a minimum be consistent with the requirements of the distribution or transmission consultation procedures (as applicable).

It is worth noting in this context that 29 November 2013 is the final date by which the AER will be required to publish the guidelines and that it may publish various guidelines in advance of that date.

12.6 Need for transitional arrangements

This final rule determination provides for a number of significant changes to Chapters 6 and 6A of the NER and also requires the AER to develop a number of guidelines by 29 November 2013. Although these guidelines will not be binding, they are intended to play an integral role in the regulatory review process going forward for the following reasons:

- service providers, the AER and the appeal body will be required to have regard to them in the context of each regulatory determination; and
- if a service provider or the AER wishes to depart from the approaches set out in the guidelines, they will be required to clearly set out the reasons for the proposed departure.

At the same time as the AER is developing the various guidelines, seven NSPs are due to submit their regulatory proposals (see table below). Another eight NSPs are due to submit their proposals within 12 months of the date by which the guidelines are to be finalised. Given the degree of overlap between the guideline development and regulatory determination processes, some form of transitional arrangement is required to:

- enable the new rules and guidelines to be applied in the next round of regulatory reviews; and
- minimise the resourcing burden that the guideline development and regulatory determination processes may otherwise place on the AER, NSPs and other stakeholders.

Table 12.2 Existing timetable for regulatory determinations

<table>
<tr><th colspan="2">NSP</th><th>Framework and Approach Paper</th><th>Regulatory Proposal Due</th><th>Regulatory Period Commences</th></tr>
<tr><td colspan="2">ElectraNet and Murraylink
(SA transmission and interconnector between Vic and SA)</td><td>n.a.</td><td>Already submitted</td><td>1 July 2013</td></tr>
<tr><td colspan="2">SP AusNet
(Vic transmission)</td><td>n.a.</td><td>28 February 2013</td><td>1 April 2014</td></tr>
<tr><td rowspan="2">2014 Group of NSPs</td><td>TransGrid and Transend
(NSW and Tas transmission)</td><td>n.a.</td><td>31 May 2013</td><td>1 July 2014</td></tr>
<tr><td>ActewAGL, Ausgrid, Endeavour Energy and Essential Energy
(ACT and NSW distribution)</td><td>30 November 2012</td><td>31 May 2013</td><td>1 July 2014</td></tr>
<tr><td colspan="2">Directlink
(Interconnector between Qld and NSW)</td><td>n.a.</td><td>31 May 2014</td><td>1 July 2015</td></tr>
<tr><td rowspan="2">2015-2016 Group of DNSPs</td><td>Ergon, Energex and SA Power Networks
(Qld and SA distribution)</td><td>30 November 2013</td><td>31 May 2014</td><td>1 July 2015</td></tr>
<tr><td>Jemena, United Energy, CitiPower, Powercor and SP AusNet
(Vic distribution)</td><td>31 May 2014</td><td>30 November 2014</td><td>1 January 2016</td></tr>
<tr><td rowspan="4">Post 2016 Group</td><td>Aurora Energy
(Tas distribution)</td><td>30 November 2015</td><td>31 May 2016</td><td>1 July 2017</td></tr>
<tr><td>Powerlink
(Qld transmission)</td><td>n.a.</td><td>31 May 2016</td><td>1 July 2017</td></tr>
<tr><td>ElectraNet
(SA transmission)</td><td>n.a.</td><td>31 May 2017</td><td>1 July 2018</td></tr>
<tr><td>Murraylink (Interconnector between SA and Vic)</td><td>n.a.</td><td>31 May 2022</td><td>1 July 2023</td></tr>
</table>

From the submissions that have been made on this issue, it would appear that most interested parties accept that some form of transitional arrangement is required for a number of the NSPs listed in Table 12.1. However, concerns have been expressed about the scope of the proposed arrangements outlined in the consultation paper and the length of time over which transitional arrangements are expected to persist. The Commission has therefore given further consideration to both:

- the period over which the transitional arrangements should apply and the NSPs that should be subject to the arrangements; and
- the form(s) that the transitional arrangements should take.

The Commission's analysis of these two matters is set out in the remainder of this chapter.

12.7 NSPs that will be subject to the transitional arrangements

In the consultation paper it was envisaged that all NSPs, except ElectraNet, Murraylink and Directlink, would be subject to the same form of transitional arrangements and that the transitional rules would need to operate for at least five years. The persistence of the arrangements through to 2017 was, at this stage, considered necessary to minimise any resourcing constraints that the AER, NSPs and other stakeholders may face during the guideline development and regulatory review processes.

Following the receipt of a number of submissions on this issue, the Commission has given further consideration to the need to have the transitional rules in operation for this length of time. To this end, the Commission has worked with the AER to determine whether, from an AER resourcing perspective,[524] transitional arrangements are required until 2017.

On the basis of the discussions the Commission has had with the AER and the Commission's own analysis, it would appear that:

- a delay of more than 12 months will be required for SP AusNet (transmission) given the proximity of the commencement of its next regulatory period to the last date by which the AER is required to finalise its guidelines;
- a 12 month delay to the full determination process will be required for those NSPs that are due to commence their next regulatory period on 1 July 2014;
- some form of transitional arrangement will be required for those NSPs that are currently due to commence their next regulatory period on 1 July 2015 and 1 January 2016 but a five month delay to the full determination process would be sufficient if certain elements of the extended consultation process were excluded;
- Directlink can follow a regulatory determination process in accordance with its existing timetable; and
- no transitional arrangements are required for NSPs with regulatory periods commencing post 2016, ie Aurora, Powerlink, ElectraNet and Murraylink.

524 It is worth noting in this context that the potential for resourcing constraints within the AER exists because regulatory processes are currently staggered. A delay in the regulatory process for one group can therefore create an overlap with other regulatory processes.

The Commission has therefore decided to:

- exclude Aurora, Powerlink, ElectraNet and Murraylink from the transitional arrangements[525] and to require them to be subject to the new rules from the commencement of their next regulatory periods;

- apply different transitional arrangements to the following groups of NSPs:

  — SP AusNet (transmission), which is due to commence its next regulatory period on 1 April 2014;

  — ActewAGL, Ausgrid, Endeavour Energy, Essential Energy, TransGrid and Transend, all of which are due to commence their next regulatory periods on 1 July 2014 (referred to in this chapter as the "2014 group of NSPs");

  — – Energex, Ergon, SA Power Networks, CitiPower, Jemena, SP AusNet (distribution), Powercor and United Energy (referred to in this chapter as the "2015-2016 group of DNPSs"). The first three of these DNSPs are due to commence their next regulatory periods on 1 July 2015 while the latter five are due to commence their next regulatory periods on 1 January 2016; and

  — Directlink, which is due to commence its regulatory period on 1 July 2014.

The Commission's final decision on the form of the transitional arrangements that will be applied to SP AusNet (transmission), the 2014 group of NSPs, the 2015-2016 group of DNSPs and Directlink is set out in the following sections.

12.8 Form of the transitional arrangements to be applied to NSPs

As outlined above, the key driver of the transitional arrangements is the requirement for the AER to develop guidelines as a basis for applying the new rules. This means that the more time that has elapsed since the guidelines have been finalised, the easier it should be for stakeholders to transition to the new rules. To put it another way, those NSPs whose regulatory proposals would, in the absence of transitional rules, have been due during, or shortly after, the completion of the AER's guidelines will require more significant transitional arrangements than those with regulatory proposals due at a later point in time.

The decline in the need for the transitional arrangements is reflected in the Commission's approach to SP AusNet (transmission), the 2014 group of NSPs and the 2015-2016 group of DNSPs.

SP AusNet (transmission), whose next regulatory period is due to commence four months after the last date by which the AER's guidelines are to be finalised, requires the most significant transitional provisions because there is insufficient time for even a

525 The only transitional rules that will apply to this group of NSPs are the provisions relating to the time at which the AER can review capex, for the purposes of identifying inefficient capex, non-arm's length margins and/or expenditure that is capitalised inappropriately.

truncated regulatory process. The existing rules must therefore be preserved for SP AusNet for a period of time. After considering a range of options, the Commission has decided that SP AusNet should be subject to the existing rules for three years before moving to the new rules on 1 April 2017.

For the 2014 group of NSPs and the 2015-2016 group of DNSPs, less significant transitional arrangements are required than for SP AusNet. In particular, it is possible for the existing timing of the regulatory periods to be maintained and for the AER's resourcing issues to be accommodated by delaying the AER's "full" determination for a period of time and using an "interim" determination for the first year of the period. For the 2014 group of NSPs the AER's "full" determination will need to be delayed by 12 months while the 2015-2016 group's determination will only need to be delayed by five months.

During the consultation process, a range of options for dealing with a delay in the 'full' determination process were canvassed (see section 12.3). Given the concerns that have been raised with the proposal set out in the consultation paper, the Commission has given further consideration to two of the other options that were canvassed during this process, ie the placeholder with true-up model and the preliminary determination with mandatory re-opener model.

As noted in section 12.3, the preliminary determination with mandatory re-opener model has a number of advantages over the placeholder with true-up model but it requires a longer consultation period than is available to the 2014 group of NSPs.[526] The Commission has therefore decided to apply the placeholder with true-up model to this group of NSPs.

In contrast to the 2014 group of NSPs, a five month delay to the 2015-2016 group of DNSPs' regulatory determination process will provide the AER with sufficient time to make a preliminary determination before the commencement of the regulatory period. Given the advantages that this model has over the placeholder with true-up model, the Commission has decided to apply the preliminary determination with mandatory re-opener model to this group of NSPs.

In the case of Directlink, the AER has indicated that it has sufficient resources to carry out its regulatory determination in accordance with its existing timetable.[527] Transitional arrangements are therefore only required to deal with the length of Directlink's regulatory determination process and the timing of its framework and approach paper process.

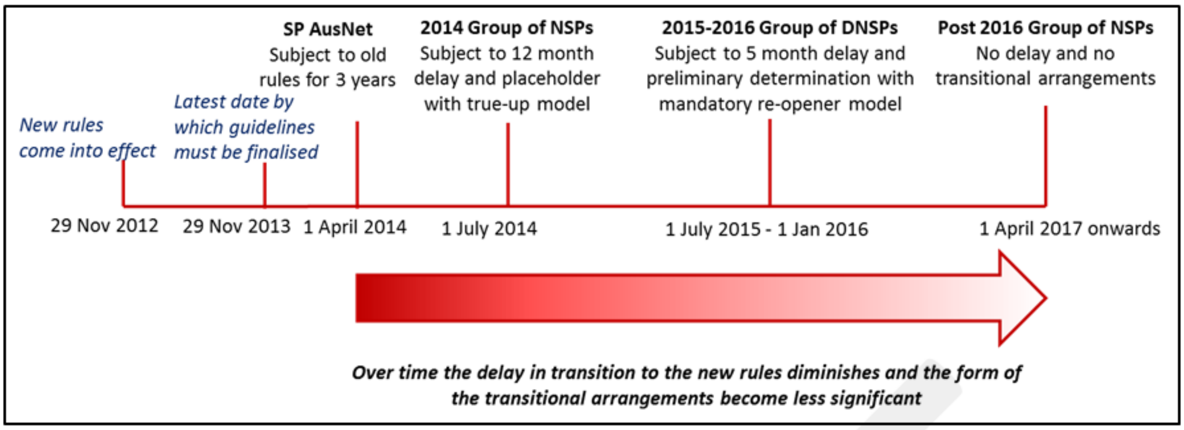
526 The application of this model would require a NSP to submit its regulatory proposal to the AER eight months before the regulatory period commences. There are, however, only seven months between the latest date by which the AER is required to finish its guidelines and when this group's regulatory period starts. The period would be even shorter if any provision was made for the NSPs to take account of the guidelines in their regulatory proposals.

527 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

For those NSPs with regulatory periods commencing post 2016, no transitional arrangements are required. Aurora, Powerlink, ElectraNet and Murraylink will therefore be subject to the new rules at the commencement of their next regulatory periods.

The form of the transitional arrangements that will be applied to each of the NSPs is summarised in the figure below.

Figure 12.1 Transitional arrangements continuum



As this figure demonstrates, the transitional arrangements that the Commission has decided to put in place may be viewed as a continuum with the time taken to transition to the new rules and the differences between the standard determination process and the transitional determination process diminishing over time.

The remainder of this chapter provides further detail on the Commission's rationale for adopting these transitional arrangements and how it intends them to be applied to SP AusNet (transmission), the 2014 group of NSPs, the 2015-2016 group of NSPs and Directlink.

Before moving on though, it is worth noting that in designing these arrangements the Commission has been mindful of the uncertainty and, in some cases, additional burden that the transitional arrangements may place on stakeholders. Given that in some cases it will be over a year until the transitional arrangements are applied, it may be that as time passes stakeholders view the need for transitional arrangements differently. For example, if the AER's resourcing was to change there may no longer be a need for transitional arrangements for the 2015-2016 group of DNSPs. It is not possible to provide flexibility for this in the rules.

12.9 Transitional arrangements to apply to SP AusNet (transmission)

SP AusNet (transmission) is currently due to submit its regulatory proposal to the AER by 28 February 2013 and commence its next regulatory period on 1 April 2014. At the same time that SP AusNet is due to submit its regulatory proposal, the AER will be developing the guidelines. Given the coincidence of SP AusNet's regulatory determination process and the guideline development process, some form of transitional arrangement is required to allow the new rules and guidelines to be applied to SP AusNet before the commencement of the subsequent regulatory period.

The four options the Commission has considered in this context are to delay SP AusNet's transition to the new rules by one, two, three or, as requested by SP AusNet,[528] 4.25 years. The Commission's views on each of these options can be summarised as follows:

- A one year delay would result in the fastest transition to the new rules. However, this option would require SP AusNet to submit its regulatory proposal within three months of the latest date by which the AER is required to finalise its guidelines. This three month period would not allow sufficient time for the framework and approach process to be carried out and would mean that other elements of the stakeholder consultation process could not be carried out. This option is therefore contrary to the second principle set out in section 12.2.

- The two year delay option overcomes the deficiencies of the first option. However, a delay of this length would mean that SP AusNet's transmission regulatory determination process would be carried out concurrently with its distribution regulatory determination process. This option is therefore likely to give rise to resourcing constraints within both SP AusNet and the AER and, in so doing, contravene the fourth principle set out in section 12.2

- The three year delay option overcomes the deficiencies identified with the one and two year delay options. It also has better incentive properties because it provides a longer regulatory period over which SP AusNet can seek out efficiencies that will benefit consumers in future regulatory periods. The one drawback of this option is, however, that it results in a slower transition to the new rules.

- The final option, which is to delay the transition to the new rules by 4.25 years, also overcomes the deficiencies identified with the first two options. However, in the Commission's view this is too long a period to wait for SP AusNet to transition to the new rules and is inconsistent with the first principle set out in section 12.2.

On balance, the Commission is of the opinion that the three year delay option is more consistent with the principles set out in section 12.2 than the other three options and that the benefits of this option outweigh the delayed transition to the new rules. SP AusNet's transmission determination will therefore be made for the period 1 April 2014 - 31 March 2017 under the older Chapter 6A rules. A new transmission determination will then be made under the new Chapter 6A rules for the regulatory period commencing on 1 April 2017.

To put this decision into context, it is worth noting that although SP AusNet will be subject to the old rules for another three years, it will be required to transition to the

528 SP AusNet, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 5.

new rules before Powerlink and ElectraNet (1 April 2017 vs 1 July 2017 and 1 July 2018). This decision is therefore consistent with the Commission's broader objective of having the new rules come into effect before the commencement of the subsequent round of regulatory determinations.

12.10 Transitional arrangements to apply to 2014 group of NSPs

ActewAGL, Ausgrid, Endeavour Energy, Essential Energy, TransGrid and Transend are due to submit their regulatory proposals to the AER by 31 May 2013 and commence their next regulatory period on 1 July 2014. At the time this group of NSPs regulatory proposals are due to submit their regulatory proposals, the AER will not have finalised its guidelines. To enable the new rules and guidelines to be applied to this group of NSPs in the next regulatory period, a 12 month delay to the full regulatory determination process is required.

Having considered a number of options for dealing with the 12 month delay, the Commission has come to the view that the placeholder with true-up model should be applied to this group of NSPs (see section 12.8). Under the placeholder with true-up model, the AER will be required to:

- conduct a high level review of a NSP's proposed revenue requirement for the transitional year (year 1) and make a binding determination 2-3 months before the commencement of that year (referred to in the remainder of this chapter as the "placeholder determination");
- make a full determination during the transitional year, for years 2-5[529] and the transitional year and use a NPV neutral true-up mechanism to account for any difference between:
  - the placeholder revenue for the transitional year; and
  - the revenue requirement for the transitional year that is established through the full determination process.

It is worth noting in this context that the true-up mechanism is an integral element of this model and will, in effect, allow the new rules and guidelines to be applied to both the transitional year and years 2-5. The inclusion of this mechanism in the model also means that a higher level and less time consuming assessment of the 2014 group of NSPs' transitional year revenue requirements can be undertaken in advance of the transitional year. The application of this model should therefore, go some way to alleviating resourcing constraints that may otherwise exist in 2013-14 for the AER and affected NSPs.

To give effect to the placeholder with true-up model, the transitional rules provide for the following regulatory periods:

- the transitional regulatory period, which will operate over the period 1 July 2014 to 30 June 2015; and;
- the subsequent regulatory period, which will operate over the period 1 July 2015 to 30 June 2019.[530]

The remainder of this section sets out how the Commission intends the placeholder with true-up model to be applied to this group of NSPs, with particular emphasis placed on:

- the placeholder determination process;
- the full determination process;
- the extent to which incentive schemes will operate in the transitional regulatory period;
- the matters to be dealt with by the AER through the framework and approach paper process; and
- the manner in which a range of ancillary issues will be treated for the transitional regulatory period.

12.10.1 Placeholder determination process

As its name suggests, the placeholder determination requires the AER to conduct a high level review of the 2014 group of NSPs' proposed revenue requirements for standard control and prescribed transmission services for the transitional regulatory period.

Given the nature of the placeholder determination and the limited time available, the transitional rules require:

- a relatively short consultation process, with the AER having just two to three months[531] to make the placeholder determination (see table below);
- the NSPs to provide the AER with indicative estimates and ranges for certain building block elements; and

529 In accordance with the transitional rules, the AER is required to approve a subsequent regulatory period of four years but a NSP may, with the AER's agreement, have a subsequent regulatory period of no less than three years or more than four years.

530 This assumes a regulatory period of four years for the subsequent regulatory period.

531 The consultation period for TNSPs is one month shorter than for DNSPs because rule 6A.24.4 states that if the AER has not made a final decision on the revenue proposal by a date that is three months prior to the commencement of the first pricing year then the draft decision will apply. Given that there will be no draft placeholder determination, the AER will be required to publish the TNSPs placeholder determination three months before the commencement of the transitional regulatory control period so that it can be used to set prices for that year.

- the AER to apply relatively high level criteria when assessing a NSP's proposal, rather than undertaking the detailed assessment that would usually be required by Chapters 6 or 6A of the rules. Put another way, the AER is not required to justify its decision about the placeholder revenue by applying a building block model to estimate a NSP's placeholder revenue requirement.

Further detail on the latter two of these aspects of the placeholder determination is set out below.

Table 12.3 Key Dates for the Placeholder Determination Process

NSP	Submission of Transitional Regulatory Proposal to the AER	AER Invites Written Submissions	AER Determination
TransGrid and Transend	31 January 2014	As soon as practicable	31 March 2014
ActewAGL and NSW DNSPs			30 April 2014

Information to be provided to the AER

Five months prior to the commencement of the transitional regulatory period, the 2014 group of NSPs will be required to provide the AER with a transitional regulatory proposal, which sets out their proposed revenue requirement for the transitional year. These NSPs will also be required to provide the following supporting information to the AER:

- an indicative estimate of the opening value of the RAB at the beginning of the transitional year;
- an indicative range for the rate of return, which has regard to the AER's rate of return guidelines, and takes into account available market information and expected market trends;
- an indicative estimate of forecast opex, capex, depreciation and corporate tax for the transitional year;
- the revenue that the NSP expects to earn from the provision of standard control or prescribed transmission services in the last year of the current regulatory period and an indicative range of its revenue requirements for the provision of those services for the transitional year and for the subsequent four years;
- a summary of the NSP's proposed expenditure for the transitional year and the subsequent four years and an explanation of how the proposal is consistent with the placeholder revenue; and
- any other information the NSP considers relevant to the AER's determination.

The transitional rules also require DNSPs that are subject to a price cap to provide the AER with indicative estimates of demand for each type of direct control service for the transitional year and the subsequent four years.

Criteria to be applied by the AER

The AER will be required to publish its final determination for the transitional regulatory period two months after receiving a TNSP's transitional regulatory proposal and three months after receiving a DNSP's proposal.[532]

The AER will only be able to approve a NSP's proposed placeholder revenue proposal if it is satisfied that:

- the amount set out in it is likely to be consistent with the NEO and the RPP; and
- recovery of that amount is reasonably likely to minimise price variations between the current regulatory control period, the transitional regulatory control period and the subsequent regulatory control period and between regulatory years.

In deciding whether or not to approve a NSP's proposed placeholder, the AER is also required by the transitional rules to have regard to the following:

- the fact that the revenue requirement for the transitional regulatory period is an estimate that is based on indicative inputs, and that the determination for the next regulatory period will provide for a true-up;
- the information included in, or accompanying, the transitional regulatory proposal;
- submissions received in the course of consulting on the transitional regulatory proposal; and
- analysis undertaken by, or for, the AER in connection with the transitional regulatory proposal.

If the AER does not approve a NSP's placeholder proposal, it must approve an amount that it is satisfied is consistent with the NEO and RPP and that recovery of which is reasonably likely to minimise price variations between regulatory control periods and regulatory years.

It is worth noting in this context that the AER is already required by section 16 of the NEL to have regard to both the NEO and the RPP when performing an economic regulatory function. The only additional criterion that the transitional rules require the AER to have regard to is therefore the "reasonably likely to minimise price variations" criterion. This criterion has been incorporated in the transitional rules to minimise the potential for the placeholder determination to result in one off price shocks. Further insight into the Commission's rationale for including this criterion in the transitional rules can be found in section 2.4-2.6.

532 Ibid.

Pricing of alternative control services by DNSPs

The preceding discussion has focused on how the revenue requirement for standard control and prescribed transmission services will be determined for the transitional regulatory period. In addition to providing standard control services, the NSW DNSPs and ActewAGL provide alternative control services.

The Commission understands that some forms of alternative control services are capable of being trued-up (eg public lighting and metering) while others are not (eg fee and quoted services). The transitional rules therefore provide for:

- the control mechanism currently applying to these services to be maintained for the transitional regulatory period, unless otherwise amended through the framework and approach paper;
- prices for these services to be rolled forward from the current regulatory period with a CPI adjustment; and
- where relevant, the AER to set out how any true-up will be carried out in the full determination process in the framework and approach paper for ActewAGL and the NSW DNSPs.

12.10.2 Full determination

The full regulatory determination process for the 2014 group of NSPs will be carried out during the transitional regulatory control period and the AER will be required to publish its final determination just before the commencement of the first year of the subsequent regulatory control period (year 2). The full determination will be carried out, with some exceptions, in accordance with the new rules and guidelines and will establish:

- the NSP's annual revenue requirement for the subsequent regulatory control period (years 2-5);
- the annual revenue requirement that would have been established for the transitional regulatory control period (year 1) if it had been subject to a full determination process; and
- the amount of any true-up that is required in years 2-5 to account for differences between the placeholder revenue and the transitional year revenue requirement established through the full determination process.

Further detail on the following matters is provided below:

- the consultation process for the full determination;
- the manner in which the true-up will be carried out;
- transitional year measurement issues;

- the manner in which the rate of return will be measured; and
- the length of the subsequent regulatory period.

Consultation process

Given the timing of the guideline development process, there is insufficient time for the 2014 group of NSPs to be subject to the extended regulatory determination process (15 months). The regulatory process for this group of NSPs will therefore be based on an 11 month regulatory process.[533]

Although a shorter regulatory process will be employed, the AER will still be required to publish a framework and approach paper for each NSP and conduct a mandatory public forum on their regulatory proposals. The NSPs will also be required to submit an overview paper when lodging their regulatory proposal and will be subject to the new rules that are intended to increase the level of customer engagement by NSPs on their regulatory proposal.

The key dates for the framework and approach paper, the submission of the regulatory proposal and the publication of decisions are set out in the table below.

Table 12.4 Key Dates for Full Regulatory Determination Process

<table>
<tr><th>NSP</th><th>Framework and Approach Paper Finalised</th><th>Regulatory Proposal Due</th><th>Final Decision</th></tr>
<tr><td>TransGrid and Transend</td><td>31 January 2014</td><td rowspan="2">31 May 2014</td><td rowspan="2">30 April 2015</td></tr>
<tr><td>ActewAGL and NSW DNSPs</td><td>Part 1: 31 March 2013*
Part 2: 31 January 2014</td></tr>
</table>

* The framework and approach paper for ActewAGL and the NSW DNSPs will be split into two, with the first part dealing with matters that are not the subject of guidelines and the second part dealing with the remaining matters (see section12.10.4). for further detail).

True-up mechanism

The true-up mechanism is an integral element of the placeholder with true-up model and will be used to account for any deviation between:[534]

- the placeholder revenue for standard control services or prescribed transmission services (as the case may be) in the transitional year; and
- the revenue requirement for standard control services or prescribed transmission services (as the case may be) for the transitional year established through the full determination process.

533 Two of the more notable elements of the new regulatory process that will not apply to this group of NSPs are the issues paper and the cross-submission process.

534 It is worth noting that the description of the true-up mechanism in this context assumes that a NSP is subject to a revenue cap. For those DNSPs that are subject to a price cap, the transitional rules require the AER to set out how the true-up will be carried out in its framework and approach paper.

To the extent that it is relevant, a separate true-up mechanism will also be used for the NSW DNSPs and ActewAGL to account for any differences between the alternative control service prices applying in the transitional regulatory period and the prices established through the full determination process.

To the extent that there is an amount that needs to be trued-up, the transitional rules require the AER to adjust a NSP's revenue requirements in years 2-5. The transitional rules also require the AER to carry out the true-up on a NPV neutral basis.

The final matter that the Commission has considered in this context is whether the requirement for a final year X factor anchor point (clauses 6.5.9(b)(2) and 6A.6.8(c)(2) of the NER) should be removed for the purposes of the transitional rules.

The Commission understands that, in principle, the final year anchor point is intended to minimise price shocks that may otherwise occur between the final year of the regulatory period and the first year of the subsequent regulatory period. However, under both the placeholder with true-up model and the preliminary determination with mandatory re-opener models, the requirement to carry out a true-up in years 2-5 could result in price volatility within this period if the anchor point is maintained.[535] The Commission has therefore decided, for the purposes of the transitional rules only, to relax this anchor point.

It is worth noting in this context that while the final year anchor point will be removed in the transitional rules,[536] the X factor provisions in Chapters 6 and 6A of the NER will still require the smoothed revenue to be equal to the NPV of the annual revenue requirement (clauses 6.5.9(b)(3) and 6A.6.8(c)(1)). That is, the required revenue can still be recovered across the period, but the smoothing can be applied more optimally.

Transitional year measurement issues

One matter that received some attention during the consultation process was whether, when making its decision on the transitional year revenue requirement during the full determination process, the AER should be able to have regard to:

- information available up to the date it makes the full determination, ie during the transitional year; or
- only information available up to the commencement of the transitional year.

535 The potential for this to occur can be seen in the following example, which assumes that prices are originally expected to move from $100 to $110 over the five years, demand is constant over the period and the operation of the true-up mechanism results in prices in years 2-5 having to rise by $20 per annum. In this example the final year anchor point effectively locks in the $110 price in year 5. The $20 increase that should have occurred in year 5 must then be spread over years 2-4, resulting in an additional increase in these three years. Over the five year period, prices would therefore move as follows: Year 1: $100; Years 2-4: greater than $120; and Year 5: $110. If the anchor point had been relaxed then prices could have moved up from $100 to $120 and remained at this level for the remaining four years rather than moving to a level above $120 and then moving back down to $110 in the final year.

536 Clauses 6.5.9(b)(2) and 6A.6.8(c)(2)

To determine how significant this issue is likely to be, the Commission has considered the information that is likely to be available to the AER when it makes its full determination.

At the time the AER is to make its decision on opex and capex allowances, it is unlikely to have much (if any) data on the expenditure actually incurred by NSPs in the transitional year. The risk of the AER having regard to new information when setting the allowances for these two elements is therefore expected to be quite low. Even if some information was available it would only be expenditure for part of the year, so the weight that the AER could place on such information is likely to be quite low.

Unlike opex and capex, rate of return parameters and other economic indicators used in the derivation of a NSP's revenue requirement are available on a more frequent basis. It is possible therefore that certain elements of the AER's full determination could differ from what they would otherwise have been if the determination had been made one year earlier.

This is a shortcoming of the placeholder with true-up model. However, it is not, in the Commission's view, sufficient enough to warrant a departure from the model, particularly given the benefits that the model offers in terms of ameliorating resource constraints and providing for a faster transition to the new rules. The Commission has therefore considered alternative options for addressing this issue.

The options that the Commission has explored include:

1. Requiring the AER to make a decision in advance of the transitional regulatory period on those elements of the NSP's revenue requirement that could differ if measured before or after the commencement of this period, ie rate of return, inflation and other escalators, and locking this in for the purposes of the full determination;

2. Including a provision within the transitional rules that restricts the AER's assessment during the full determination process to information and data available in the lead up to the transitional year. In effect, this option would require the AER to ignore any information or data released in the ten month period between the commencement of the transitional year and the date on which it makes its final determination; or

3. Leaving it to the AER to exercise its judgement, having regard to both the NEO and RPP.

The problem with the first of these options is that there is insufficient time between the likely release of the AER's guidelines and the commencement of the transitional regulatory period for the level of consultation that would be required to make a decision of this nature. The Commission has therefore rejected this option.

The second option is also problematic because trying to restrict the AER to considering data and information that was available 10 months before it makes its full determination is likely to be difficult to implement in practice. Another shortcoming of this option is that it could result in substantial resources being dedicated by the NSPs and the AER (and potentially an appeals body) to distinguishing between information and data that was available before or after the commencement of the transitional year. Of greater significance though, is the potential for the adoption of this option to result in a decision that is inconsistent with the NEO and RPP.[537] Given these shortcomings, the Commission has also rejected this option.

The final option is to leave the decision to the AER and allow it to be guided by the NEO and RPP. In the Commission's opinion, this is the most practical solution given:

- the limited time available in the lead up to the transitional year;
- the difficulties associated with not being able to take into account relevant information; and
- the more fundamental need to ensure that regulatory decisions are consistent with the NEO and RPP.

Since section 16 of the NEL already requires the AER to have regard to these matters when performing an economic regulatory function or powers, no transitional rules are required to give effect to this option.

Measurement of the rate of return

Another issue that was raised during the consultation process was how the rate of return should be measured over the transitional and subsequent regulatory periods.

There was general consensus amongst the AER and the NSPs that a single rate of return should apply across the two regulatory periods rather than two separate rates of return for each period.[538] However, different views were expressed about the period over which the rate of return to apply over the five years should be measured, ie in the lead up to the transitional year or in the lead up to year 2. Notwithstanding the differences in opinion on this issue, the AER and NSPs appear to see benefits in a framework and approach paper process being used to:[539]

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537 For example, if the rate of return rose by 2% in the lead up to the full determination and this was ignored then it may, depending on the financial arrangements the NSP had in place, be argued that the AER's decision did not provide the NSP with an opportunity to recover at least efficient costs (section 7A(2) of the NEL).

538 See for example, QTC, Consultation Paper on Savings and Transitional Arrangements submission, 24 October 2012, p. 2; Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 5-6; UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1; and CitiPower and Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

539 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 10, SA Power Networks, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 3-4; Energex, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2; Ergon Energy, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 5-6; UE and MG, Consultation Paper on Savings and Transitional Arrangements submission, 26 October 2012, p. 1; and CitiPower and

- specify any market observation period that may be required under the AER's rate of return guidelines, to measure the rate of return; and
- set out the AER's view on the methodologies that it is likely to accept for the measurement of the return on debt component of the overall rate of return.

The Commission understands the desire of both the AER and the NSPs to have a single rate of return applying over the two regulatory periods and nothing in the transitional rules precludes this.

The Commission also recognises the desire of NSPs to have some degree of certainty about how the return on debt is likely to be measured before they undertake any refinancing or hedging. However, the new rules do not prescribe the way that the AER must estimate the rate of return beyond being required to achieve an overall rate of return objective. Furthermore, the new rules do not require the approach to estimating the rate of return to involve the use of an averaging period or return on debt methodology to be specified in advance of a regulatory determination. The Commission is reluctant therefore to make a transitional rule that will mandate an approach that is not required by the new rules and which may pre-empt the approach the AER ultimately adopts in its guidelines.

Although the Commission has decided not to deal with this issue through the transitional rules it is of the view that, to the extent it is relevant under the AER's approach for estimating the rate of return in its guidelines, the AER could use the existing framework and approach paper process[540] to consult with NSPs on:

- any measurement period that may be required to measure the rate of return; and
- the methodologies that it intends to employ when measuring the rate of return.

The Commission understands from the following statement contained in the AER's submission that it has already given some consideration to this issue and may be willing to use the framework and approach paper process for this purpose: [541]

'To allow for efficient debt risk management, it is important that the determination process accommodates sufficient and timely certainty in terms of key approaches and processes. Accordingly, the published Framework and Approach paper could appropriately be used to establish any necessary processes for determining the rate of return, such as the timing of any 'sampling period'.'

Powercor, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

540 Note that the framework and approach paper provisions in Chapters 6 and 6A already allow the AER to use the framework and approach paper to set out its likely approach to any matter that it thinks fit to give an indication on. No specific transitional rules are therefore required to direct the AER to deal with this issue through the framework and approach paper process.

541 AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 10.

Length of the subsequent regulatory period

To enable the combined length of the transitional and subsequent regulatory periods to be five years, the transitional rules allow for the use of a four year regulatory period for the subsequent regulatory period.

The transitional rules also allow the 2014 group of NSPs to propose, and permit the AER to approve, a regulatory period of three or more years. This provision has been incorporated into the transitional rules to enable the NSPs and the AER to optimise the alignment of regulatory reviews across all NSPs. Although the Commission views the alignment of particular regulatory determinations as a separate issue from the transitional arrangements, it understands that it may be desirable from both a resourcing and benchmarking perspective, to allow certain groups of NSPs to be subject to a regulatory review at the same time. It has therefore decided to make provision for this to occur in the transitional rules.

12.10.3 Operation of incentive schemes in the transitional year

Incentive schemes are applied to individual NSPs through the regulatory determination process. The targets for these schemes, or the basis upon which they are calculated, are set out in the final determination for each NSP. As these schemes are intended to drive a particular form of behaviour by NSPs (such as maintaining and improving service standards) the targets for the schemes are required to be known prior to the relevant period. As outlined above, a full regulatory determination will not be made for the transitional year until well into that year for the 2014 group of NSPs. Transitional arrangements are therefore required to deal with incentive schemes for these NSPs.

In its consultation paper the Commission suggested that incentive schemes should not operate in the transitional year as a means of reducing the number of decisions the AER would be required to make for the transitional year determination.[542] Following the receipt of a large number of submissions on this issue, the Commission has reconsidered this proposal.

In short, the Commission is of the view that incentive schemes should, to the extent that it is practical and appropriate to do so, apply in the transitional regulatory period. To account for those cases where it may not be appropriate to apply particular schemes in the transitional year, or where a different method may be required in that year, the Commission is of the view that the AER should have sufficient flexibility to deal with this through the framework and approach paper process. The transitional rules therefore require the AER to set out in the framework and approach paper how the schemes will apply in the transitional regulatory period and in the subsequent regulatory period.

542 AEMC, Consolidated Rule Request – Economic Regulation of Network Service Providers, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, p. 13.

Before setting out the Commission's views on the particular schemes, it is worth noting the following general points:

- the framework and approach paper will be issued before the start of the transitional regulatory period. NSPs should therefore be able to respond to the incentives created by the schemes in the transitional year;
- the AER will not be able to go back and revisit the targets and values that it sets for the transitional year through the framework and approach paper; and
- where rewards/penalties (revenue increments/decrements) from incentive schemes are accrued in the current regulatory period and due to be applied in the transitional year, these will be accounted for in the following regulatory years as part of the true-up mechanism. This includes for example the s-factor.

The Commission's views on each of the schemes are set out below.

The proposed varied STPIS for transmission and the existing STPIS for distribution can apply in some form for the transitional year. The Commission notes that the AER and NSPs broadly agree that the targets and revenue at risk for the last year of the STPIS for distribution can be used for the transitional year. There is also broad agreement that a parameter by parameter approach to setting targets for the transitional year for the STPIS for transmission can work.

The Demand Management and Embedded Generation Incentive Scheme[543]can also apply in some form for the transitional year. The Commission does not consider it necessary to provide for fall back arrangements in the transitional rules for this scheme as proposed by stakeholders.[544] Instead, the AER can stipulate the approach through the framework and approach paper.

The existing EBSS is unlikely to be able to operate. This is because the operating expenditure allowance is currently a key input into this scheme and this information will not be available until near the end of the period. However, the Commission notes that the AER intends to review the scheme in 2013. For this reason the possibility of an EBSS applying in the transitional year should not be ruled out. Further, even if the EBSS is to have no effect, it may need to apply for the year in some form for the continued smooth operation of the scheme (eg targets for the year may need to be set to actual expenditure).

The Commission maintains that capex sharing schemes and small scale incentive schemes should not operate in the transitional years for the 2014 group of NSPs. This decision is made on the basis that these schemes have not been applied before. These schemes can commence in the subsequent regulatory period (years 2-5).

543 This includes the NSW D-factor scheme.

544 See for example, AER, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 11.

The new rules provide for the AER to review the efficiency of past capex and to make consequent adjustments to capex that would otherwise be rolled into the RAB. The Commission's view is that these adjustments should not apply in respect of capital expenditure that is incurred prior to or during the transitional year. This is because a NSP will not know what its capital expenditure allowance is for the transitional year until towards the end of the period and the capex incentive guidelines will not have been published prior to any year that precedes the transitional year.

Similarly, the AER will not be able to reduce the capex that would otherwise be rolled into the RAB, by virtue of it representing a non-arm's length margin or the capitalisation of opex, where that capex is incurred in a regulatory year that commences before the capex incentive guidelines have been published.

In relation to depreciation, for consistency the use of actual or forecast depreciation to calculate the opening value of the RAB for both the transitional and subsequent regulatory control periods will be as set out in the current regulatory determination. The AER will determine the method to be used to establish the opening RAB for the regulatory year following the subsequent regulatory control period, when it makes the subsequent regulatory determination. The AER should, however, set out the method it intends to use in the framework and approach paper.

12.10.4 Matters to be dealt with in the framework and approach paper

The framework and approach paper process precedes the normal regulatory determination process and, in this case, also precedes the placeholder determination process. Given the timing of this process, the framework and approach paper will be used to set out how the AER intends to deal with a number of matters for the transitional regulatory period, such as:

- how the incentive schemes will operate for this period (see section 12.10.3);
- the manner in which any true-up between the placeholder and full determination will be carried out for DNSPs that are subject to a price cap form of regulation; and
- the manner in which any true-up will be carried out for DNSPs providing alternative control services that are capable of being trued-up (eg public lighting and metering).

The NER do not limit the matters that can be covered in the framework and approach paper, so to the extent that it is relevant, given the content of the AER's rate of return guidelines, the framework and approach paper consultation process may also be used to identify:

- the manner in which any measurement period that may be required to calculate the return on debt or the return on equity will be identified; and

- the methodologies that the AER intends to employ when measuring the return on debt and the return on equity and how it considers those methodologies will contribute to the overall rate of return objective.

Because some of the guidelines that form the basis for the framework and approach paper may not be finalised until the end of November 2013, the framework and approach paper consultation process will be divided into two parts for the NSW DNSPs and ActewAGL:

- Part 1 will be finalised by 28 March 2013 and will cover matters that are not the subject of guidelines; and
- Part 2 will be developed after the new guidelines are being finalised and will set out the AER's proposed approach on the remaining matters specified in the rules and other matters relating to the transitional year. This part of the framework and approach paper will be finalised by 31 January 2014.

For TransGrid and Transend, the matters to be dealt with in the framework and approach paper are largely dependent on the AER's guidelines. Consultation on the framework and approach paper will therefore commence as each of the guidelines are finalised and will culminate in a finalised framework and approach paper by 31 January 2014.

The Commission is aware that an end date for the finalisation of the framework and approach paper of 31 January 2014 is two months later than what would normally occur under the framework and approach process. However, it is also cognisant of the fact that if some of the guidelines are not completed until 29 November 2013, then additional consultation may be required before the framework and approach paper is finalised. The transitional rules therefore require the AER to finalise the framework and approach papers for the 2014 group by 31 January 2014.

One important point that is worth bearing in mind in this context is that while the transitional rules specify the last date by which the framework and approach paper is to be published, they do not specify when consultation on the paper should commence. If it is assumed that it will not take the AER up to 29 November 2013 to finalise all of the guidelines, then consultation on certain elements of the framework and approach paper could commence as soon as the individual guidelines are published rather than waiting until all of the guidelines are finalised.

Staggering the consultation in this manner would provide more time to consult on each of the matters that the AER is required to deal with in the framework and approach paper. It will also provide NSPs with a good idea of the AER's intention on particular matters earlier than what would otherwise occur if the consultation period did not commence until 29 November 2013. The Commission therefore encourages the AER to commence consultation on particular matters as soon as the individual guidelines are published.

Finally, it is worth noting that the Commission is aware that some of the NSPs in the 2014 group are of the view that:

- they should be subject to the draft rather than the final guidelines; and
- the guidelines should set out how they are to be applied to particular NSPs in the transitional period.

On the first of these matters, the final guidelines will be developed in sufficient time for the NSPs to have recourse to them when preparing their regulatory proposals. The Commission therefore disagrees with the proposal for this group of NSPs to be subject to the draft rather than the final guidelines.

On the second matter, the Commission is of the opinion that these issues are better dealt with through the framework and approach paper rather than through the guidelines, which are not intended to apply in a NSP-specific manner. It does not therefore support this proposal.

12.10.5 Treatment of ancillary issues for the transitional year

To minimise the number of decisions the AER will be required to make in the placeholder determination, the transitional rules provide for a number of decisions to be:

- carried over from the current regulatory determination, eg negotiating frameworks and negotiated transmission/distribution service criteria;[545][546] or
- carried over from the current regulatory determination, unless otherwise provided for in the framework and approach paper, eg classification of services and the form of control mechanism for standard control and alternative control services.[547]

The transitional rules relating to pass through events also provide for:

- those events identified in the current regulatory determination to be carried over; and

545 For DNSPs the decisions that are to be carried over from the current regulatory determination include: the negotiating framework; the negotiated distribution service criteria; the procedures for assigning/reassigning retail customers in relation to tariff classes; the proposed pricing methodology for transmission standard control services; the application of Part J of Chapter 6A to services provided by dual function assets; and the manner in which the value of the opening regulatory asset base will be calculated at commencement of the next regulatory period (ie on the basis of forecast or actual depreciation).

546 For TNSPs the decisions that are to be carried over from the current regulatory determination include: the negotiating framework; the negotiated transmission service criteria; and the pricing methodology.

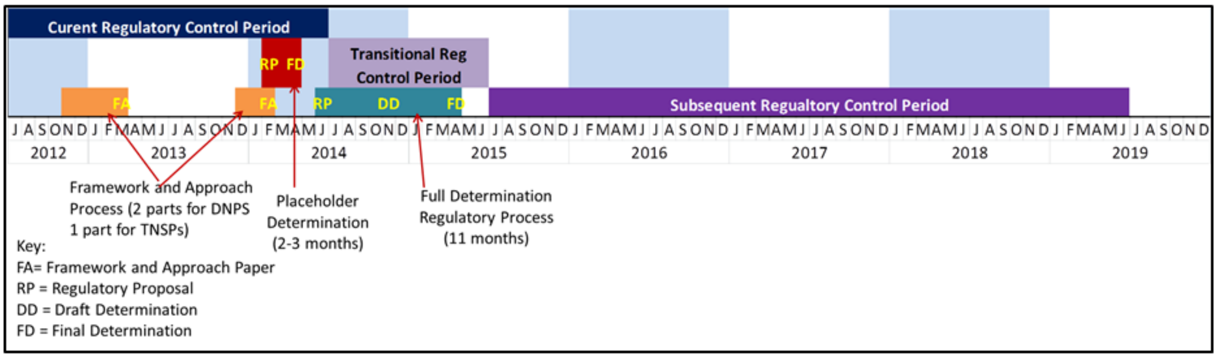
547 For DNSPs the decisions that are to be carried over from the current regulatory determination, unless otherwise provided for in the framework and approach paper include: the classification of distribution services; the form of control mechanism for standard control services; and the form of control mechanism for alternative control services.

- the inclusion of the previously repealed "terrorism event".[548]

12.10.6 Consistency of the transitional arrangements with principles

To summarise, the Commission has decided to delay the full regulatory determination process for the 2014 group of NSPs by 12 months and use the placeholder with true-up model to deal with the transitional year. The application of this model gives rise to two regulatory periods and two determination processes. The relationship between the various elements of this model and the timing of each element is depicted in Figure 2.

Figure 12.2 2014 Group of NSPs Regulatory Determinations and Periods



The Commission's view on the consistency of these transitional arrangements with the principles set out in section 12.2 can be summarised as follows:

- *Principle 1: final rules to apply as soon as possible* - The inclusion of the true-up mechanism in the model means that, with the exception of the extended regulatory process provisions, the new rules and guidelines will apply in both the transitional year and the subsequent four years. The model therefore results in a faster transition to the new rules than the model specified in the consultation paper and will effectively result in the final rules substantially applying from 1 July 2014.

- *Principle 2: sufficient time for consultation* - The consultation period for the placeholder determination will be relatively short given the nature of the decisions to be made at the time, but sufficient time for stakeholder consultation will be made in the full determination process when the AER is actually assessing the revenue requirements by reference to the new rules. Delaying the

548 In the current regulatory control period for NSPs, a terrorism event is a specified pass through event under the NER. However, in the *National Electricity Amendment (Cost pass through arrangements for network service providers) 2012 No. 4*, a "terrorism event" was removed from the list of specified pass through events in the NER that will apply to NSPs from their next regulatory control period on the basis that if a NSP wished to, it could nominate the terrorism event as an additional pass through event in its regulatory proposal. NSPs subject to these transitional arrangements will not be able to nominate additional pass through events for the transitional year so the transitional rule has been drafted such that, for the transitional year, the "terrorism event" is a specified pass through event under the NER.

full regulatory determination process by 12 months will also enable greater participation by interested parties in the guideline development process.

- *Principle 3: opportunity to recover at least efficient costs* - Because the new rules and guidelines will be effectively applied to both the transitional regulatory period and subsequent regulatory period, the application of these transitional arrangements will have no effect on a NSP's opportunity to recover at least the efficient costs they incur in the provision of regulated services over the five year period.

- *Principle 4: arrangements practicable having regard to resourcing constraints* - The true-up mechanism allows a more high level assessment to be undertaken in advance of the transitional year because it takes into account any difference between the placeholder value and the revenue requirement that would have been derived if the new rules had been applied. The adoption of this model should therefore go some way to alleviating the resourcing constraints that the AER, the 2014 group of NSPs and other stakeholders may otherwise face in 2013-14.

- *Principle 5: minimising price volatility* - The requirement for the AER to have regard to the "reasonably likely to minimise price variations" criterion when assessing a NSP's placeholder revenue proposal should ameliorate the potential for price shocks that may otherwise occur if a single year determination was made.

It follows from this assessment that, in the Commission's opinion, the transitional arrangements to be applied to the 2014 group of NSPs are consistent with the principles set out in section 12.2, and the NEO and RPP, more generally (see sections 2.4-2.6).

12.10.7 Specific arrangements for ActewAGL

Through discussions with the AEMC, ActewAGL has indicated that a 12 month delay to its electricity regulatory process would result in a direct overlap between its gas and electricity regulatory processes and, in so doing, give rise to "serious resourcing issues". ActewAGL has therefore requested that the submission date for its proposed revisions to the ACT, Queanbeyan and Palerang gas distribution network access arrangement be delayed by 12 months.

The Commission recognises that ActewAGL is relatively small and that requiring it to conduct its gas and electricity determination processes concurrently is likely to give rise to resourcing constraints. Such an outcome would obviously be at odds with the fourth principle in section 12.2 and, if not addressed, could compromise the regulatory process. The Commission has therefore decided to allow ActewAGL's gas access arrangement review submission date to be delayed by 12 months to 1 July 2015 and to enable the effect of any delays to be dealt with in accordance with rule 92(3), which states the following:

"…if there is an interval (the **interval of delay**) between a revision commencement date stated in a full access arrangement and the date on which revisions to the access arrangement actually commence:

- reference tariffs, as in force at the end of the previous access arrangement period, continue without variation for the interval of delay but;
- the operation of this subrule may be taken into account in fixing reference tariffs for the new access arrangement period."

In its discussion with the AEMC, ActewAGL raised some concerns about the strength of the latter of these provisions and whether the AER would actually be compelled to undertake a true-up. The Commission accepts that the use of the word "may" in this provision appears to provide the AER with some discretion as to whether a true-up will be carried out. However, it must be borne in mind that when exercising discretion, the AER is required to have regard to both the NGO and the RPP. In the Commission's opinion, these sections of the NGL would support the application of a true-up mechanism if the reference tariffs prevailing in the period of delay were lower (higher) than what they would otherwise have been.

It is worth noting in this context that the Commission's view on this issue is consistent with the view expressed by the AER in its recent draft decision for the Victorian gas access arrangement review, as demonstrated by the following extract:[549]

> "There will be a delay in the making of the final decision. The AER has therefore taken into account the operation of r. 92(3) of the NGR in fixing reference tariffs for the 2013–17 access arrangement period. The AER considers that the 2013 reference tariffs under the 2013-17 access arrangements should take effect from 1 July 2013 until 31 December 2013.
>
> The AER considers that the interval of delay should not result in service providers incurring a windfall gain or loss, compared with what would have occurred if the 2013-17 access arrangements had taken effect from 1 January 2013. This approach is consistent with the efficiency objectives under the NGO and long term interest of gas consumers. This approach will also provide service providers with a reasonable opportunity to recover at least the efficient costs of providing reference services as approved in the access arrangements, consistent with the RPP."

Given the manner in which the AER has indicated it will apply this provision, the Commission is satisfied that rule 92(3) can be relied upon to deal with the effect of any delay in ActewAGL's gas access arrangement review process.

To give effect to the 12 month delay, the gas transitional rules will therefore:

549 AER, Access arrangement draft decision Envestra Ltd 2013-17 Part 1, September 2012, p277.

- allow the AER to extend the period for submitting an access arrangement revision proposal by up to 18 months under rule 52(3) of the NGR; and

- require the AER to exercise its power under the modified rule to extend ActewAGL's period for submission to 30 June 2015.

Finally, it is worth noting that while ActewAGL's revised access arrangement will be delayed by 12 months, the Commission expects that any true-up the AER carries out will result in the new NGR being effectively applied to the transitional year. The timing of the application of the new NGR to ActewAGL's gas distribution network should therefore be unchanged as a result of the 12 month delay.

12.11 Transitional arrangements to apply to 2015-2016 group of DNSPs

Energex, Ergon and SA Power Networks are currently required to submit their regulatory proposals to the AER by 31 May 2014 while CitiPower, Jemena, Powercor, SP AusNet (distribution) and United Energy are due to submit their proposals by 30 November 2014. Although the submission date for this group of NSPs is 6-12 months after the latest date by which the AER is required to finalise its guidelines, the 12 month delay to the 2014 group of NSPs' full determination process is expected to result in a material increase in the AER's workload over the period 31 May 2014 – 30 April 2015. Some insight into the workload the AER would face in this period if the 2015-2016 group were not subject to transitional arrangements can be found in the table below.

Table 12.5 Regulatory determinations in 2014-2015 if 12 month delay to 2014 group of NSPs and no delay to 2015-2016 group of DNSPs

NSP	Regulatory Determination Process
TransGrid and Transend	31 May 2014 - 30 April 2015*
ActewAGL, Ausgrid, Endeavour Energy and Essential Energy	31 May 2014 - 30 April 2015*
Directlink	31 May 2014 - 30 April 2015*
Ergon, Energex and SA Power Networks	31 May 2014 - 30 April 2015*
CitiPower, Jemena, Powercor, SP AusNet and United Energy	30 November 2014 – 31 October 2015*
NSW Gas access arrangement review	30 Jun 2014 – 31 May 2015

* Note that the length of this process assumes that these NSPs would not be subject to the extended consultation process.

To minimise the resourcing constraints that may otherwise exist in this period, the Commission has decided to delay the commencement of the regulatory determination processes for the 2015-2016 group of DNSPs by five months[550]and require a 12 month, rather than a 15 month, regulatory determination process.

550 A delay of this length will eliminate any overlap between the Victorian regulatory determination process and the 2014 group of NSPs and Directlink regulatory determination processes. It will also reduce the overlap between the Queensland regulatory determination process and the 2014 group of NSPs and Directlink regulatory determination processes by five months.

A delay of this length will not give the AER enough time to make a final determination before the commencement of the next regulatory periods (1 July 2015 or 1 January 2016, as the case may be). However, it will provide the AER with sufficient time to make a preliminary determination[551] (equivalent in practice to a draft determination) two months before the commencement of that regulatory period. The Commission has therefore decided to apply the preliminary determination with mandatory re-opener model to this group of DNSPs.

At its most elementary, this model involves:

- using the AER's draft determination as a placeholder for a NSP's revenue requirement and prices until the final determination is made; and

- using an adjustment mechanism to account for any difference between the draft and final determinations.

This model is referred to as the "preliminary determination with mandatory re-opener model" because, from a legal perspective, a binding (final) determination must be in place prior to the start of a regulatory period. The application of this model therefore requires:

- a final determination to be made in advance of the regulatory control period. In effect, what would have been the draft determination under a full determination process becomes the final determination. Because of its subsequent re-opening, this determination is referred in this chapter to the "preliminary determination";

- a mandatory re-opening of the preliminary determination and the substitution of this determination with a new determination by the AER ("substitute determination"). In effect, the new determination is the final determination that would have arisen through the usual determination process; and

- any differences between the preliminary and substitute determinations to be accounted for in the substitute determination through a NPV neutral adjustment.

It is the Commission's intention that the decision-making rules that would ordinarily apply to the making of a final determination will apply equally to the making of the substitute determination. It is also intended that consultation between the preliminary and substitute determinations be equivalent to the process set out in clauses 6.10.2-6.10.3 of the NER. DNSPs will therefore have an opportunity to submit a revised regulatory proposal and other stakeholders will also have an opportunity to make written submissions.

Before setting out how this model will work in practice, it is worth noting that it has a number of distinct advantages over the placeholder with true-up model, which the Commission considers warrant its application when there is sufficient time to do so:

551 This determination may be regarded as a 'preliminary determination' because it will be re-opened shortly thereafter.

- First, the process to be followed and the decisions that the AER is required to make are in all practical respects equivalent to those it would have to make under a standard regulatory determination process. This includes the consultation process between the preliminary and final determination, which is intended to be the same as that between a standard draft and final determinations;
- Second, the true-up can be seen as analogous to that which is required between a final determination and the outcome of a merits review at the moment, so the concept of this type of true-up is familiar to stakeholders;
- Third, it provides a more robust basis for establishing this group's annual revenue requirements and prices than the placeholder determination process because the determination will be made in accordance with the new Chapter 6 rules rather than the high level criteria outlined in section 12.10.1;
- Fourth, it overcomes the measurement issues associated with the placeholder with true-up model because the AER's preliminary determination will be made before the commencement of the regulatory period; and
- Fifth, it will provide the DNSPs and other stakeholders with a greater degree of certainty about how the rate of return will be measured before the commencement of the regulatory period than is provided under the placeholder with true-up model.

The preliminary determination with mandatory re-opener model also has a number of advantages over clause 6.11.3(b). This clause states that if a period intervenes between the end of one regulatory control period and the commencement of a new determination, then the prior determination continues in force and appropriate adjustments can be made in the later determination. The advantages that the preliminary determination with mandatory re-opener model has over this clause are that it will:

- allow the new rules to come into effect earlier than clause 6.11.3(b);
- be more likely to result in prices in the first regulatory year that are closer to those established in the substitute determination than what would occur if prices were carried over from the prior determination;
- provide NSPs and other stakeholders with a greater degree of certainty about the rate of return that will apply over the regulatory period before the commencement of the period; and
- avoid a number of measurement issues and the need to have a regulatory determination applying for a partial year (ie 4.5 years).

The remainder of this section sets out how the Commission intends the preliminary determination with mandatory re-opener model to be applied to the 2015-2016 group of DNSPs, with particular emphasis placed on:

- the key stages of the preliminary and substitute determination process;
- the operation of incentive schemes;
- the time at which changes between the preliminary and substitute determinations will be taken into account; and
- other aspects of the transitional rules that will apply to this group of DNSPs.

12.11.1 Stages of the preliminary and substitute determination process

The preliminary determination with mandatory re-opener model consists of the following stages:

- the framework and approach stage;
- the regulatory submission and consultation stage;
- the preliminary determination stage, which is equivalent in practice to a draft determination;
- the consultation between preliminary and substitute determination stages, which is equivalent in practice to what occurs between a draft and final determination; and
- the substitute determination stage, which is equivalent in practice to a final determination.

Further detail on each of these stages is provided below.

Framework and approach paper stage

Under the new Chapter 6 rules, if there is an existing framework and approach paper in place and a DNSP has not requested the AER to make an amended or replacement framework and approach paper, the AER will only be required to amend or replace the paper if it concludes that it is necessary or desirable to do so. Although there is some optionality around this provision, the Commission would expect the AER to publish a new or amended framework and approach paper for this group of DNSPs, because it will need to deal with a number of new issues that were not required under the old framework and approach paper provisions. It may also need to use the framework and approach paper to set out the manner in which incentive schemes will operate in the first year of the regulatory process.

In accordance with the transitional rules, the framework and approach paper will need to be published six months before the 2015-2016 group of DNSPs submit their regulatory proposals.

Submission of regulatory proposals and initial consultation stage

At the time the 2015-2016 group of DNSPs are due to submit regulatory proposals, there is still expected to be some workload congestion within the AER. It is not therefore possible to build in any additional consultation time in the lead up to the preliminary determination for the publication of an issues paper.

Although this group of DNSPs will not be subject to the extended regulatory process, they will still be required to submit an overview paper when lodging their regulatory proposals. They will also be subject to those rules that are intended to increase the level of customer engagement by NSPs when developing their regulatory proposal. In addition, the AER will be required to conduct a mandatory public forum on the regulatory proposals at the commencement of the process.

In accordance with the transitional rules, this group of DNSPs will be required to submit their regulatory proposals eight months before the commencement of the regulatory period.

Preliminary determination stage (equivalent in practice to a draft determination)

The transitional rules, in conjunction with Chapter 6 of the NER, require the AER to publish the preliminary determination[552] two months prior to the commencement of the regulatory period. The process that the AER will follow to make the preliminary determination will in practice be identical to the process it would have followed to make a draft determination. This determination will have the status of the final determination until it is replaced by the substitute determination. DNSPs will therefore be required to have recourse to the determination when preparing their annual pricing proposals for the first year of the regulatory period.

When making the preliminary and substitute determinations, the AER will apply the same NEL and Chapter 6 provisions, and hence if faced with the same information it could be expected to make the same decision in both cases. In practice the revised regulatory proposal and the responses of stakeholders to the preliminary determination provides the AER with additional information that could mean its substitute determination differs from the preliminary determination.[553] It is possible therefore that the AER will have additional information when making the substitute determination as compared to the preliminary determination.

Notwithstanding this possibility, all stakeholders, including the AER and affected NSPs, have an interest in minimising the difference between the preliminary and substitute determinations to minimise the scale of any subsequent adjustment and

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552 As noted in the introduction to this section, the application of the preliminary determination with mandatory re-opener model requires a binding determination to be made in advance of the regulatory control period. So what would have been the draft determination under a full determination process becomes a final determination. Because of its subsequent re-opening, this determination is referred to in this chapter as the "preliminary determination".

553 Note that the transitional rules leave in place the same consultation provisions and requirement to provide a revised regulatory proposal as set out under the standard determination process set out in Chapter 6 of the NER.

price volatility. Minimising the extent of any difference can be helped by the AER, affected NSPs and other stakeholders:

- providing information to the AER as early as possible;
- engaging in as much consultation as possible and as early as possible in the regulatory determination process. The consultation requirements in the rules are only ever a minimum set of requirements and do not in any way restrict the degree of additional consultation that can be undertaken; and
- trying to establish areas of agreement amongst stakeholders on issues that might usually be left to later in the determination process

Consultation between the preliminary and substitute determination stages

As soon as the preliminary determination is made, the AER will be required to publish an invitation for written submissions on the revocation and substitution of that determination. Although it is necessary to give practical effect to these transitional arrangements by requiring the AER to re-open the preliminary determination, in all other respects the arrangements are intended to be equivalent to those that would normally apply between a draft and final determinations. The consultation process is therefore intended to be equivalent to the process that would normally apply between the draft and final determination stages. NSPs will therefore be required to submit their revised regulatory proposals and any other submissions to the AER within a specified period of time and other stakeholders will also have the opportunity to make submissions on the preliminary determination.

Workload congestion within the AER is expected to diminish at the end of April 2015 when the AER publishes its final determinations for the 2014 group of NSPs. Provision will therefore be made for an extra month to be built into the regulatory process between the preliminary and substitute determinations to provide:

- NSPs an additional 15 business days to prepare their revised regulatory proposals and other stakeholders an additional 15 business days to make any submissions to the AER; and
- the AER an additional five business days to make its substitute determination.

It is worth noting in this context that the Commission has considered whether any additional time should be made for the cross submission stage and other elements of the extended regulatory process. However, it is of the opinion that it was more important to have the substitute determination in place soon after the commencement of the regulatory period, given that certain elements of the substitute determination will become operative as soon as the determination is made (see section 12.11.3).

Substitute determination stage

The transitional rules require the AER to revoke the preliminary determination and replace it with the substitute determination[554] no later than four months into the first year of the regulatory period. In making this substitute determination, the AER will be required to have regard to the same matters that it is usually required by Chapter 6 to consider when making a final determination.

The AER will also be required to make provision for any adjustment that may be required to account for differences between the preliminary and substitute determinations, including, if appropriate, by allowing adjustments to be made to an existing or future approved pricing proposal. In accordance with the transitional rules, any adjustment that may be required is to be carried out on a NPV neutral basis.

To ensure that any adjustment that may be required does not result in price volatility over years 2-5, the requirement for a final year X factor anchor point (clause 6.5.9(b)(2) of the NER) to be used when smoothing will be removed for the purposes of the transitional rules only (see section 12.10.2 for further detail).

Finally, it is worth noting that the substitute determination will be subject to merits review under the NEL as reviewable regulatory decision because it will:

- be a distribution determination within the meaning of the NEL. This is because it will be a determination of the AER under the rules that regulates either the prices a DNSP can charge for direct control services (standard control services and alternative control services) or the revenues the DNSP can earn from the provision of those services; and
- “set a regulatory period” as the AER will be required, as part of making the substitute determination, to make a decision under clause 6.12.1(2)(ii) on the commencement and length of the regulatory control period.

Key dates

The key dates for the framework and approach paper, the submission of the regulatory proposal, the preliminary determination and the substitute determination for the 2015-2016 group of DNSPs are set out in the table below. As the information in this table reveals, the overall length of the regulatory determination process is 12 months.

554 As noted in the introduction to this section, the application of this model requires the mandatory re-opening of the preliminary determination and the substitution of this determination with a new determination made by the AER ("substitute determination"). In effect, the substitute determination is the final determination that would have arisen through the usual determination process.

Table 12.6 Key Dates for 2015-2016 Group of DNSPs

	Framework and Approach Paper Finalised	Regulatory Proposal Due	Preliminary Determination	Substitute Determination	Regulatory period*
Queensland and South Australian DNSPs	30 Apr 2014	31Oct 2014	30 Apr 2015	31 Oct 2015	1 July 2015-30 June 2020
Victorian DNSPs	31 Oct 2014	30 Apr 2015	31 Oct 2015	30 Apr 2016	1 Jan 2016-31 Dec 2020

* Note that, with the agreement of the AER, a regulatory period of no less than three years or more than five years could be adopted.

12.11.2 Operation of incentive schemes

As set out in section 12.10.3, the Commission is of the view that incentive schemes should, to the extent it is possible and appropriate, apply in each year of the regulatory period. In keeping with this approach, the Commission is of the view that:

- to the extent possible, the whole suite of incentive schemes should operate as normal during the 2015-2016 group of DNSPs next regulatory period; and
- the proposed application of the incentive schemes should be set out in the AER's framework and approach paper and, where relevant, the AER should have the flexibility to apply schemes differently in the first year.

In relation to the application of the new review of efficiency of past capex provisions, the AER will have the ability to preclude capex from being rolled into the RAB where it is inefficient, represents non-arm's length margins or inappropriate capitalisation of expenditure. The AER's ability to exercise this discretion will, however, be limited to regulatory years following the publication of the capex incentive guidelines as set out in sections 9.4 and 9.5.

In relation to depreciation, the AER will have discretion to decide whether actual or forecast capex will be used to establish the opening value of the RAB for the following regulatory period.

12.11.3 Accounting for differences between determinations

The preliminary determination will be made two months before the commencement of the 2015-2016 group of DNSPs' regulatory periods and will remain in place until the AER revokes and replaces it with the substitute determination. The remainder of this section sets out the Commission's views on the time at which changes between the preliminary and substitute determinations should be taken into account.

Changes in the prices of standard control services

Once the AER releases the preliminary determination, DNSPs will be required to prepare their annual pricing proposal for the first year of the regulatory period. To provide retailers and end-users with some certainty about the prices to be paid for standard control services in the first year, the Commission expects the price of standard control services appearing in the approved pricing proposal to be maintained in that year.

Any adjustments that may be required to account for differences between the price of standard control services established in the preliminary and substitute determinations and the fact that this element of the preliminary determination will prevail throughout year 1, should therefore be carried out in years 2-5.

Changes in the price of alternative control services

The alternative control services provided by the 2015-2016 group of DNSPs consist of a mixture of services that can be subject to a true-up adjustment (eg public lighting and metering services) and those that cannot (eg fee services and quoted services). The Commission's view on how changes in the price of alternative control services between the preliminary and substitute determinations should be dealt with can be summarised as follows:

- for those services that can be subject to a true-up adjustment, the Commission expects the prices appearing in the approved pricing proposal to be maintained for the duration of the first year and any true-up to be applied in years 2-5; and
- for those services that *cannot* be trued-up, the Commission is of the view that these prices should be revised as soon as the substitute determination is made.

A different approach can be applied to the latter types of alternative control services because there is no other avenue for the DNSPs to recoup (repay) the difference between the preliminary and substitute determinations. Allowing prices to be revised as soon as the substitute determination is made will therefore minimise the effect of any loss (gain) that may otherwise arise if the substitute determination allows higher (lower) prices.

Ancillary issues

To the extent that there is any change in position by the AER between the preliminary determination and the substitute determination on matters that do not affect the price of standard control services, these should take effect as soon as the substitute determination is made. These elements include:

- pass through events;
- the negotiation framework;
- the negotiated distribution service criteria;
- the procedures for assigning/reassigning retail customers in relation to tariff classes;
- the proposed methodology for transmission standard control services; and

- the application of Part J of Chapter 6A to services provided by dual function assets.

12.11.4 Length of the regulatory period

In addition to giving effect to the preliminary determination with re-opener model, the transitional rules also allow the 2015-2016 group of NSPs to propose, and permit the AER to approve, a regulatory period less than five years but not less than three years. This provision has been incorporated into the transitional rules to enable the NSPs and the AER to optimise the alignment of regulatory reviews across all NSPs (see section 12.10.2).

12.11.5 Consistency of the transitional arrangements with principles

To summarise, the Commission has decided to delay the regulatory determination process for the 2015-2016 group of DNSPs by five months and to use the preliminary determination with mandatory re-opener model to deal with this delay. The Commission's view on the consistency of these transitional arrangements with the principles set out in section 12.2 can be summarised as follows:

- *Principle 1: final rules to apply as soon as possible* – Apart from the extended regulatory determination process, the new rules and guidelines will apply to this group of DNSPs from the commencement of the next regulatory period.

- *Principle 2: sufficient time for consultation* - The consultation period for the preliminary and substitute determinations is one month longer than the existing 11 month period and will therefore provide sufficient time for consultation.

- *Principle 3: opportunity to recover at least efficient costs* - The application of this transitional arrangement will have no adverse effect on the ability of the DNSPs to recover at least their efficient costs because the new rules and guidelines will apply over the entire period and any difference between the preliminary and substitute determinations will be accounted for through appropriate adjustments carried out on a NPV neutral basis.

- *Principle 4: arrangements practicable having regard to resourcing constraints* – A five month delay to the commencement of the 2015-2016 group of DNSPs' regulatory determination processes will ameliorate the workload congestion that would otherwise exist within the AER between 31 May 2014 and 30 April 2015 if the arrangements were not implemented. Although there will still be a degree of overlap during this period, the AER has informed the Commission that the proposed arrangements are workable.

- *Principle 5: minimising price volatility* – there is no a priori reason to expect that the application of this transitional arrangement will result in one-off price shocks. Indeed, the Commission considers this approach has the potential to minimise shocks to a greater extent than the placeholder with true-up model because the preliminary determination is made by applying the same legal requirements as the substitute determination.

Overall, the Commission is of the opinion that the transitional arrangements to be applied to the 2015-2016 group of NSPs are consistent with the principles set out in section 12.2, and the NEO and the RPP, more generally (see sections 2.4-2.6).

12.12 Transitional arrangements to be applied to Directlink

Directlink is currently due to submit its regulatory proposal to the AER by 31 May 2014 and its next regulatory period is due to commence on 1 July 2015.

Given the relatively small size of Directlink, the Commission has decided not to subject it to the same transitional arrangements that have been proposed for both the 2014 and 2015-2016 groups of NSPs. The new rules will therefore apply to Directlink from the commencement of the next regulatory period.

Although Directlink's regulatory determination process will not be delayed, the timing of its next regulatory period is such that transitional rules are required to:

- enable the final form of the AER's guidelines to be taken into account during the framework and approach paper process. To this end, the framework and approach paper will be required to be finalised by 31 January 2014 (see section 12.10.4); and
- reduce the length of the regulatory determination process from 15 months to 11 months. Although Directlink will not be subject to the extended regulatory determination process, it will still be required to submit an overview paper with its regulatory proposal and will be subject to the new rules that are intended to increase the level of customer engagement by NSPs when developing their regulatory proposals. The AER will also be required to conduct a mandatory public forum on Directlink's regulatory proposal.

12.13 Summary and timetable for next round of determinations

The Commission's decision on the NSPs that should be subject to the transitional arrangements and the form that these arrangements should take can be summarised as follows:

- SP AusNet (transmission) will be subject to the old Chapter 6A rules for three years before transitioning to the new rules on 1 April 2017;
- ActewAGL, Ausgrid, Endeavour Energy, Essential Energy, TransGrid and Transend (the 2014 group of NSPs) will have their full regulatory determination processes delayed by 12 months and will be subject to the placeholder with true-up model. Given the limited time available, the regulatory determination process will be carried out over an 11 month period rather than a 15 month period;

- Energex, Ergon, SA Power Networks, CitiPower, Jemena, Powercor, SP AusNet and United Energy (the 2015-2016 group of DNSPs) will have their regulatory determination processes delayed by five months and will be subject to the preliminary determination with mandatory re-opener model. At the time these determinations processes are due to commence, there will still be some workload congestion for the AER. The regulatory determination processes will therefore be carried out over a 12 month period rather than a 15 month period;

- Directlink will not be subject to a delay in its regulatory determination process. However, because there is limited time available between the last date by which the AER's guidelines are to be finalised and its regulatory period, Directlink's regulatory determination process will be carried out over an 11 month period rather than a 15 month period; and

- Aurora, Powerlink, ElectraNet and Murraylink will be subject to the new rules, including the 15 month extended regulatory determination process, for their next regulatory periods.

To give effect to these arrangements, separate transitional rules have been developed for SP AusNet (transmission), the 2014 group of NSPs, the 2015-2016 group of DNSPs and Directlink. Transitional rules have also been developed to:

- require the AER to finalise all of the guidelines by 29 November 2013 and issue a statement by 21 December 2012 setting out its proposed schedule and the consultation procedure to be followed when preparing the guidelines; and

- specify when the AER's review of capex, for the purpose of identifying inefficient capex, non-arm's length margins and /or expenditure that is capitalised inappropriately, can commence.

These transitional rules are set out in Part ZW in Chapter 11.

The effect that these transitional rules will have on the regulatory determination process can be seen in Table 12.6, which sets out the timetable for the next round of regulatory determinations.

In addition to these electricity related transitional rules, a transitional rule has been included in the NGR to enable ActewAGL's proposed revisions to the ACT, Queanbeyan and Palerang gas distribution network access arrangement to be delayed by one year.

Table 12.7 New timetable for regulatory determination processes

NSP		Form of Transitional Arrangement	Next Regulatory Period: Length	Next Regulatory Period: Dates	Framework and Approach: Consultation Commences*	Framework and Approach: Paper Published	Regulatory Process: Regulatory Proposal Due	Regulatory Process: Draft Decision*	Regulatory Process: Final Decision	Regulatory Process: Length
Transmission										
SP AusNet (Vic)	Next Determination	Old rules for 3 years	3 years	1 Apr 2014 –31 Mar 2017	n.a.	n.a.	28 Feb 2013	31 Aug 2013*	31 Jan 2014	11 months
	Subsequent Determination	New rules	5 years	1 Apr 2017-30 Mar 2022	30 Sep 2014§	30 Apr 2015	31 Oct 2015	30 Jun 2016*	31Jan 2017	15 months†
TransGrid, Transend (NSW and Tas)	Placeholder Determination	Placeholder with true-up	1 year	1 Jul 2014- 30 Jun 2015	n.a.	n.a.	31 Jan 2014	n.a.	31 Mar 2014	2 months
	Full Determination		4 years″	1 Jul 2015- 30 Jun 2019	30 Nov 2013	31 Jan 2014	31 May 2014	30 Nov 2014*	30 Apr 2015	11 months^
Directlink (Interconnector btw Qld and NSW)		New rules	9 years+	1 Jul 2015-30 Jun 2024	30 Nov 2013§	31 Jan 2014	31 May 2014	30 Nov 2014*	30 Apr 2015	11 months^
Powerlink (Qld)		No transitional arrangements§	5 years	1 Jul 2017- 30 Jun 2022	31 Dec 2014§	31 Jul 2015	31 Jan 2016	30 Sep 2016*	30 Apr 2017	15 months†
ElectraNet (SA)			5 years	1 Jul 2018- 30 Jun 2023	31 Dec 2015§	31 Jul 2016	31 Jan 2017	30 Sep 2017*	30 Apr 2018	15 months†
Muarraylink (Interconnector btw Vic and SA)			10 years+	1 Jul 2023- 30 Jun 2033	31 Dec 2020§	31 Jul 2021	31 Jan 2022	30 Sep 2022*	30 Apr 2023	15 months†
Distribution										
ActewAGL, Endeavour Energy, Essential Energy and Ausgrid (ACT and NSW)	Placeholder Determination	Placeholder with true-up	1 year	1 Jul 2014-30 Jun 2015	n.a.	n.a.	31 Jan 2014	n.a.	30 Apr 2014	3 months
	Full Determination		4 years″	1 Jul 2015-30 Jun 2019	Part 1: 31 Oct 2012 Part 2: 30 Nov 2013	Part 1: 31 Mar 2013 Part 2: 31 Jan 2014	31 May 2014	30 Nov 2014*	30 Apr 2015	11 months^
Ergon, Energex and SA Power Networks (Qld and SA)		Preliminary Determination with mandatory re-opener	5 years″	1 Jul 2015-30 Jun 2020	30 Sep 2013	30 Apr 2014	31 Oct 2014	30 Apr 2015°	31 Oct 2015	12 months#
Jemena, United Energy, CitiPower, Powercor and SP AusNet (Vic)			5 years″	1 Jan 2016-31 Dec 2020	31 Mar 2014	31 Oct 2014	30 Apr 2015	31 Oct 2015°	30 Apr 2016	12 months#
Aurora Energy (Tas)		No transitional arrangements	5 years	1 Jul 2017- 30 Jun 2022	31 Dec 2014	31 Jul 2015	31 Jan 2016	30 Sep 2016*	30 Apr 2017	15 months†

Notes: * Indicative dates only because the dates for making a draft determination are not prescribed in the rules + Estimate only based on an assumption that Murraylink and Directlink seek to maintain the existing term of their regulatory periods. ″ The transitional rules allow for a shorter regulatory period if the NSP proposes a shorter period and the AER approves the proposal. § Mandatory framework and approach stage because it is the first one for this NSP. ° These dates are fixed because the preliminary determination must be made two months before the commencement of the regulatory period. Key to elements of extended regulatory process: ^ Overview paper and mandatory public forum † All elements of extended regulatory process # Overview paper, mandatory public forum, additional time for NSP to submit revised regulatory proposal, and additional time for stakeholders to make submissions on draft determination and revised regulatory proposal.

13 Gas transitional arrangements

Summary

- The only change in this final rule determination that affects the NGR is the amendment to the rate of return provisions.
- A key element of these provisions is the requirement for the relevant regulator to develop guidelines setting out the approach it intends to take when estimating a service provider's rate of return. The new rule will require these guidelines to be finalised by 29 November 2013.
- ATCO Gas' Mid-West and South-West Gas Distribution System and APA Group's Goldfields Gas Pipeline are the only pipelines affected by the timing of the implementation of the new framework.
- To ensure that the new rate of return framework can be applied to these two pipelines in the next round of access arrangement reviews, the transitional arrangements will permit:
  - the next Mid-West and South-West Gas Distribution System access arrangement revisions to be submitted by ATCO Gas up to three months after the ERA publishes the final rate of return guidelines; and
  - the next Goldfields Gas Pipeline access arrangement revisions to be submitted by APA Group up to six months after the ERA publishes the final rate of return guidelines.
- To the extent that the postponement of the proposed access arrangement revisions gives rise to a delay in the commencement of the revisions, the following will occur:
  - the reference tariffs in force at the end of the existing access arrangement will continue without variation; and
  - the ERA will be allowed to take into account the effect of any delay when setting reference tariffs in the new access arrangement period.

13.1 Introduction

The only change in this final rule determination that affects the NGR is the amendment to the rate of return provisions (see chapter 6). A key element of the new arrangements is the requirement for both the AER and the ERA to develop guidelines that set out the approach they intend to take to estimate the rate of return required by service providers (see section 6.5). Although the rate of return is determined as part of each access arrangement decision, the guidelines are an important part of the process and the Commission expects the guidelines to act as the starting point for each decision. In accordance with the new rule, the AER and the ERA will be required to publish the final rate of return guidelines by 29 November 2013.

Based on the current timetable for access arrangement revisions, the only gas service providers that will be affected by the timing of the implementation of the new rate of return framework are:[555]

- ATCO Gas, which is due to submit its proposed revisions to the Mid-West and South-West Gas Distribution System access arrangement five months before the ERA is due to publish the final rate of return guidelines, on 1 July 2013; and
- APA Group, which is due to submit its proposed revisions to the Goldfields Gas Pipeline access arrangement one month after the ERA is due to publish the final rate of return guidelines, on 1 January 2014.

Given the overlap between the rate of return guideline development process and the access arrangement review process, the Commission has given further consideration to the transitional arrangements that could be put in place to:

- ensure that the new rate of return framework is applied to both ATCO Gas and APA Group during the next access arrangement review process;
- provide ATCO Gas and APA Group with sufficient opportunity to take into account the ERA's rate of return guidelines when developing their respective access arrangement revisions;
- ensure that ATCO Gas and APA Group have a reasonable opportunity to recover at least the efficient costs; and
- minimise the resourcing burden that the transitional arrangements and guideline development processes could otherwise place on the ERA and other stakeholders.

The remainder of this chapter is structured as follows:

- Section 13.2 provides further detail on the consultation process and the transitional arrangements that were proposed in the 14 September 2012 consultation paper;
- Section 13.3 summarises the submissions received in response to the consultation paper;
- Section 13.4 sets out the Commission's analysis of the alternative transitional arrangements that have been proposed for ATCO Gas and APA Group and its final determination on the form that these arrangements should take; and
- Section 13.5 provides guidance on the final rule.

555 All other gas service providers in eastern and Western Australia are due to submit revised access arrangements from mid-2014 onwards.

13.2 Consultation process

On 14 September 2012, the AEMC published a consultation paper on the arrangements that could be applied to both gas and electricity service providers to facilitate the transition to the new rule and on 28 September 2012 conducted a stakeholder workshop. The consultation paper, amongst other things, set out:

- the principles that the Commission considered should guide the development of any transitional arrangements (see section 3.6); and
- the arrangements that could be put in place to facilitate the transition of ATCO Gas and APA Group to the new rate of return framework.

An overview of the transitional arrangements that were proposed in the consultation paper is provided below.

13.2.1 Transitional arrangements proposed for ATCO Gas

ATCO Gas is currently due to submit its proposed revisions to the Mid-West and South-West Gas Distribution System access arrangement to the ERA on 1 July 2013, with the revisions to take effect from 1 July 2014. If the current timetable is maintained, ATCO Gas would submit its proposed access arrangement revisions five months before the ERA is required to publish its final rate of return guidelines (29 November 2013).

To enable the new rate of return framework to be applied to ATCO Gas in the next access arrangement period and to ensure that ATCO Gas would have an opportunity to take into account the final guidelines, the consultation paper proposed that ATCO Gas:

- prepare its proposed revisions to the Mid-West and South-West Gas Distribution System access arrangement on the basis of the draft rate of return guidelines;
- submit its proposed revisions one month after the scheduled review submission date (1 August 2013) so that it had time to take into account the ERA's draft rate of return guidelines before submitting its proposed revisions; and
- be given the opportunity to amend its proposed revisions if there was a material difference between the draft and final versions of the guidelines.

13.2.2 Transitional arrangements proposed for APA Group

APA Group is currently due to submit its proposed revisions to the Goldfields Gas Pipeline access arrangement to the ERA on 1 January 2014, with the revisions to take effect from 1 January 2015. If the current timetable is maintained, APA Group would be required to submit its proposed access arrangement revision one month after the ERA is required by the new rule to publish its final rate of return guidelines.

To ensure that APA Group had sufficient time to take into account the final guidelines, the consultation paper proposed that APA Group:

- prepare its proposed revisions to the Goldfields Gas Pipeline access arrangement on the basis of the draft rate of return guidelines; and
- be given the opportunity to amend its proposed revisions if there was a material difference between the draft and final versions of the guidelines.

13.3 Submissions on consultation paper

Responses to this element of the consultation paper were received from the ERA, ATCO Gas and APA Group.

Overall, it appears that ATCO Gas and APA Group accept the premise upon which the transitional arrangements outlined in the consultation paper were based.[556] That is, they accept that some form of transitional arrangement is required to enable the new rate of provisions to be applied in their next access arrangement review process.[557] That said, they do have some concerns with the scope of the arrangements proposed in the consultation paper.

ATCO Gas' concerns primarily relate to:

- the requirement that it prepare its proposed access arrangement revisions on the basis of the draft rather than the final rate of return guidelines;[558] and
- the limited time it would have to take into account the draft guidelines before submitting its proposed access arrangement revisions and to subsequently amend its proposal once the final guidelines are published.[559]

Given its concerns with these elements of the proposal set out in the consultation paper, ATCO Gas proposes the use of an alternative arrangement that would involve:

- postponing the Mid-West and South-West Gas Distribution System review submission date to the later of 1 January 2014 and 3 months after the publication of the final rate of return guidelines;[560]

556 APA Group, Draft Rule Determination submission, 4 October 2012, pp. 3-4 and ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 8.

557 APA Group, Draft Rule Determination submission, 4 October 2012, pp. 3-4 and ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 8.

558 ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 6.

559 ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, pp. 3-4.

560 ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 1.

- postponing the Goldfields Gas Pipeline review submission date by a further six months to minimise the effect of the delay in the Mid-West and South-West Gas Distribution System review process on the ERA's work program;[561] and
- accounting for the effect of any delay in the revisions commencement date specified in the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline in accordance with rule 92(3) of the NGR, which ATCO Gas submits provides for:[562]
  - the reference tariffs prevailing at the end of the current access arrangement period to continue to operate; and
  - a NPV based true-up to occur when the access arrangement revisions come into effect.

In a similar manner to ATCO Gas, APA Group has some concerns with the proposal that it prepare the Goldfields Gas Pipeline access arrangement revisions on the basis of the draft, rather than the final rate of return guidelines. In APA Group's view, ATCO Gas and APA Group should have at least three months after the finalisation of the rate of return guidelines to submit their proposed access arrangement revisions.[563]APA Group is also of the view that:[564]

- any revisions required as a result of a trigger event (rule 51) should be subject to the same transitional arrangements; and
- any delay in the revisions commencement date arising as a result of the postponement of review submission dates should be dealt with through rule 92(3).

In contrast to the position taken by ATCO Gas and APA Group, the ERA is of the opinion that the transitional arrangements outlined in the consultation paper are unnecessary and could give rise to significant resourcing constraints within the ERA.[565] Specifically, the ERA is of the opinion that: [566]

- a one month delay to ATCO Gas' review submission date is unnecessary because the processes to develop the rate of return guidelines and to evaluate ATCO Gas' proposed access arrangement revisions are complementary, not sequential;

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561 ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 4.

562 ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 2.

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

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

565 ERA WA, Consultation Paper on Savings and Transitional Arrangements submission, 18 October 2012, pp. 1-3.

566 ERA WA, Consultation Paper on Savings and Transitional Arrangements submission, 18 October 2012, pp. 2-3.

- a transitional provision allowing amendments to be made to ATCO Gas' and APA Group's proposed access arrangements is also unnecessary because the ERA intends to publish the final guidelines before the ATCO Gas draft decision. The ERA submits that by publishing the final guidelines at this stage both service providers would have an opportunity to revise their proposed access arrangements; and
- any delay in the access arrangement review process could impose significant costs on the ERA and other stakeholders and place significant pressure on the ERA's constrained resources.

In subsequent discussions with the ERA about the ATCO Gas and APA Group proposal, the ERA maintained its view that the guideline and access arrangement review processes could be undertaken concurrently. The ERA noted, however, that if the review submission date for the Mid-West and South-West Gas Distribution System is to be deferred until three months after the release of the final rate of return guidelines, the transitional arrangements should:

- enable the review submission date for the Goldfields Gas Pipeline to be deferred by up to six months after the guidelines are finalised; and
- be sufficiently flexible to deal with:
  - any changes in the timing of the release of the final rate of return guidelines; and
  - the potential for ATCO Gas and APA Group to submit their proposed access arrangement revisions earlier, if they are in a position to do so.

The ERA also noted that any delay in the revisions commencement date arising as a result of the postponement of the review submission date could be accommodated through the operation of rule 92(3),[567] which allows for the effect of any delay on reference tariffs to be trued-up in the subsequent regulatory period.

Finally, it is worth noting that the Commission also received a submission from ActewAGL on the transitional arrangements that could be applied to its gas distribution network to accommodate the electricity transitional arrangements. This matter is dealt with in section 12.10.7.

13.4 Analysis

To enable the new rate of return framework to be applied in the next round of access arrangement reviews, transitional arrangements are required for ATCO Gas' Mid-West and South-West Gas Distribution System and APA Group's Goldfields Gas Pipeline. In the consultation paper published on 14 September 2012, the Commission set out one way in which the transitional arrangements could operate.

567 Further detail on rule 92(3) can be found in the following section.

This proposal did not receive any support from the ERA or the two service providers that would be the subject of the arrangements. In short, the ERA is of the view that transitional arrangements are unnecessary, while ATCO Gas and APA Group are of the opinion that the arrangements outlined in the consultation paper do not go far enough.

Given the diversity of positions taken on this issue, the Commission has given further consideration to:

- the necessity for any transitional arrangements; and;
- the form that any transitional arrangements should take.

Further consideration has also been given to the development process for the rate of return guidelines.

The Commission's assessment of each of these issues is set out in the remainder of this section.

13.4.1 Guideline development

In the draft rule determination and draft rule the Commission set out a timetable for the development of the rate of return guidelines. The Commission has given further consideration to whether this level of prescription is required in the rule and is now of the opinion that:

- the NGR should simply require the first guidelines to be finalised by 29 November 2013; and
- the relevant regulator should have some flexibility to determine the dates on which key milestones will be achieved.

To ensure that service providers and other stakeholders have sufficient notice and certainty upfront, the ERA and the AER will be required by the transitional provisions to publish a statement by 21 December 2012 that sets out:

- the proposed schedule, including milestones and dates, for the rate of return guidelines; and
- the specific consultation procedure to be followed for the rate of return guidelines, which must be consistent with the rate of return consultative procedures.

13.4.2 Need for transitional arrangements

Under the new rate of return framework, the ERA will be required to develop guidelines that set out the methodologies that it intends to have regard to when determining the rate of return for service providers (see section 6.5).

As noted in section 6.5, the guidelines will not be binding. However, the Commission expects service providers, the ERA and the appeal body to have regard to them as a starting point for each access arrangement decision. If a service provider wishes to depart from the methodologies specified in the guidelines, then it must clearly set out in its access arrangement information the reasons for the proposed departure. The rate of return guidelines are therefore intended to play an integral role in the access arrangement review process.

Although the new rule will take effect on 29 November 2012, the guidelines are not required to be finalised until the end of November 2013. There will therefore be a gap between the date the new rule comes into effect and when the guidelines are in place.

The Commission disagrees with the position taken by the ERA that no transitional arrangements are required and notes that some form of the guidelines must be in place when ATCO Gas and APA Group are preparing their proposed access arrangement revisions. Whether or not it is the draft or final version of the guidelines is a separate question, which is considered in further detail in the following section. For current purposes, it is sufficient to note that the degree of overlap between the two processes means that without transitional arrangements:

- ATCO Gas is unlikely to have access to any form of the guidelines when preparing its proposed revisions; and
- APA Group would have less than a month to take into account the final guidelines when preparing its proposed revisions.

Given this overlap, the Commission remains of the view that transitional arrangements are required to ensure the new rate of return framework can be applied to ATCO Gas and the APA Group in the next access arrangement review process.

13.4.3 Initial submission based on draft or final guidelines

One of the issues raised in the ATCO Gas and APA Group submissions is whether the two service providers should be required to prepare their access arrangement revisions on the basis of either:

1. the draft rate of return guidelines and then have the opportunity to amend their respective proposed revisions once the guidelines are finalised; or
2. the final rate of return guidelines.

At the time the consultation paper was prepared, the first of these options was considered more appropriate because it minimised the potential for any delay in the revisions commencement date for the two pipelines in question. On reflection, the Commission accepts that, given the important role the rate of return guidelines are expected to play in an access arrangement review process, this option is not ideal. The Commission also recognises the potential for this option to result in:

- higher regulatory costs and delays to the review process, if there is a significant change in the ERA's position between the draft and final guidelines; and
- a greater burden being placed on the ERA, service providers and other stakeholders at a stage in the process where there is limited time available to the ERA to make its final decision.

The Commission has therefore given further consideration to the second option. On the one hand, this option is likely to result in lengthier delays to the commencement of revisions but on the other hand it will circumvent the need for:

- ATCO Gas and APA Group to amend their proposed access arrangement revisions once the guidelines are finalised; and
- any further consultation during the access arrangement review process.

Another benefit of this option is that it will provide the two service providers with greater certainty and clarity about how the ERA intends to apply the new rate of return framework, when preparing their respective proposals.

On balance, the Commission is of the view that the benefits of having the final guidelines in place before requiring revisions to be submitted to the ERA are likely to outweigh the effect of any delay in the commencement of the revised access arrangements. It follows that, in the Commission's view, the proposal to postpone the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline access arrangement review processes is appropriate.

The implications that the Commission's position on this issue will have for the transitional arrangements to be applied to ATCO Gas' Mid-West and South-West Gas Distribution System and APA Group's Goldfields Gas Pipeline are considered in the following section.

13.4.4 Form of the transitional arrangements

To give effect to the position outlined above, the transitional provisions, in conjunction with the existing NGR, will need to specify:

- the time by which the proposed access arrangement revisions for the Mid-West and South-West Gas Distribution System and the Goldfields Gas Pipeline are to be submitted to the ERA;
- how any delays between the revision commencement date specified in the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline access arrangements and the date the revisions actually take effect will be dealt with; and
- what will happen if a trigger event occurs before the ERA's guidelines are finalised.

These matters are considered, in turn, below.

Review submission dates

To ensure that ATCO Gas and APA Group have sufficient time to take into account the final guidelines when preparing their proposed access arrangement revisions, the Commission has given further thought to the extension that may be required.

ATCO Gas and APA Group have both suggested that they should have at least three months between the release of the final guidelines and the date by which they will be required to submit their proposed access arrangement revisions.

To get an understanding of the effect that this type of delay would have on the ERA's resources, the AEMC has had further discussions with the ERA. The ERA has informed the AEMC that if a three month gap is applied to the Mid-West and South-West Gas Distribution System then, from a resourcing perspective, the Goldfields Gas Pipeline review should commence within six months of the release of the guideline.

The ERA has also suggested that, rather than defining a specific date for the revision submission date, the transitional provisions should state that the Mid-West South-West Gas Distribution System (Goldfields Gas Pipeline) revisions are to be submitted within three (six) months of the release of the final guidelines. The ERA has informed the AEMC that this type of reference point would enable the timing of the revision submission date to be varied if the guidelines were either early or late.

The Commission agrees with the ERA that there should be sufficient flexibility in the transitional arrangements to deal with:

- any changes in the timing of the release of the final rate of return guidelines; and
- the potential for ATCO Gas and APA Group to submit their proposed access arrangement revisions earlier, if they are in a position to do so.

The only outstanding issue that must be considered in this context is the length of time that ATCO Gas and APA Group will require to take into account the final form of the guidelines in their proposed access arrangement revisions.

The Commission does not have a definitive view on this issue because the time required will depend on, amongst other things, the materiality of the change in the ERA's position between the draft and final version of the guidelines and the overall complexity of the guidelines. The decision that follows should not therefore be construed as representing the Commission's general position on the length of time a service provider would need to submit their regulatory proposal following the finalisation of the guidelines.

For the purposes of these transitional arrangements, the Commission has had regard to the following matters when forming its view on the length of time that ATCO Gas and APA Group should have to submit their proposed access arrangement revisions:

- the suggestion made by both ATCO Gas and APA Group that there should be at least a three month gap between the finalisation of the ERA's guidelines and their respective review submission dates;
- the ERA's preference for the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline access arrangement review processes to be staggered; and
- the ERA's suggestion that sufficient flexibility should be built into the transitional arrangements to allow ATCO Gas and APA Group to submit their proposed revisions earlier, if they are in a position to do so.

Taking all of these factors into account, the Commission is of the view that the transitional arrangements should permit:

- the next Mid-West and South-West Gas Distribution System access arrangement revisions to be submitted by ATCO Gas up to three months after the ERA publishes the final rate of return guidelines; and
- the next Goldfields Gas Pipeline access arrangement revisions to be submitted by APA Group up to six months after the ERA publishes the final rate of return guidelines.

It is worth noting in this context that the Commission's position on the Mid-West and South-West Gas Distribution System review submission date differs somewhat from ATCO Gas' proposal. Under ATCO Gas' proposal, it would be required to submit its revisions by the later of 1 January 2014 and three months after the publication of the guidelines.

The Commission understands that the reference point of 1 January 2014 was intended to provide ATCO Gas and other stakeholders with a degree of certainty about the earliest date by which revisions would need to be submitted.[568] In the Commission's view, sufficient clarity about the date by which the revisions are required to be submitted will be provided by:

- the new rule, which specifies the last date by which the guidelines are to be finalised (29 November 2013); and
- the statement that the ERA will be required to publish by 21 December 2012, which sets out its proposed schedule, including milestones and dates, for the rate of return guidelines.

The Commission does not therefore consider it necessary to incorporate the 1 January 2014 reference point in the transitional provisions.

568 ATCO Gas, Consultation Paper on Savings and Transitional Arrangements submission, 25 October 2012, p. 13.

Finally, it is worth noting that the Commission is cognisant of the constraints that the ERA faces and appreciates the flexibility it has shown in offering to accommodate any delay in the access arrangement review processes.

Accounting for the effect of delays to the revision commencement date

Postponing the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline review submission dates is expected to result in a delay in the commencement of the access arrangement revisions for these two pipelines. Although not ideal, there are existing provisions within the NGR that set out what is to occur when there is a delay between the revision commencement date specified in an access arrangement and the date on which revisions actually commence. Specifically, rule 92(3) states that:

> "'…if there is an interval (the **interval of delay**) between a revision commencement date stated in a full access arrangement and the date on which revisions to the access arrangement actually commence:
>
> (a) reference tariffs, as in force at the end of the previous access arrangement period, continue without variation for the interval of delay; but
>
> (b) the operation of this subrule may be taken into account in fixing reference tariffs for the new access arrangement period.'"

In the course of its discussions with the Commission about the effect of postponing the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline review submission dates, the ERA has confirmed that rule 92(3) could accommodate any delay in the commencement of the revisions. The Commission also understands that the ERA has used this provision to deal with delays in the commencement date of both the 2010-2014 Mid-West and South-West Gas Distribution System access arrangement[569] and the 2011-2015 Dampier to Bunbury Natural Gas Pipeline access arrangement.[570] In both of these cases, the reference tariffs prevailing at the end of the previous access arrangement period continued for the duration of the delay and a NPV neutral true-up was carried out on a smoothed basis when the new reference tariffs were approved.[571]

Given the manner in which this provision has been utilised by the ERA, the Commission is satisfied that rule 92(3) can be relied upon to deal with the effect of any delay between:

- the revision commencement date specified in the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline access arrangements; and

569 ERA, Final Decision on WA Gas Networks Pty Ltd proposed revised access arrangement for the Mid-West and South-West Gas Distribution Systems, 28 February 2011, para 764.

570 ERA, Final Decision on Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline, 31 October 2011, para 797.

571 See for example, para 764 of ERA, Final Decision on WA Gas Networks Pty Ltd proposed revised access arrangement for the Mid-West and South-West Gas Distribution Systems, 28 February 2011.

- the date that the revisions actually take effect for these two pipelines.

No additional transitional provisions are therefore required to deal with this type of delay.

One final point that is worth noting in this context, is that during its discussions with the Commission, the ERA noted the potential for a delay in the commencement date of the Mid-West and South-West Gas Distribution System access arrangement to give rise to bridging finance related costs. The Commission is aware that this was an issue in the last access arrangement review process[572] and recognises the potential for it to recur if there is a significant delay in the revisions commencement date. However, the Commission is of the view that the ERA is best placed to deal with this issue when assessing ATCO Gas' proposed access arrangement provisions. No provision has therefore been made within the transitional provisions to deal with this issue.

Effect of trigger mechanisms

The final matter that the Commission has considered is whether transitional arrangements may be required to deal with trigger events that would otherwise require the submission of revisions before the rate of return guidelines are finalised.[573]

At the outset it is worth noting that the Commission recognises the important role that trigger events can play in an access arrangement. That said, it is possible that if these mechanisms are triggered before the ERA finalises the guidelines they could undermine the transitional arrangements outlined above. To ensure that this does not occur, the Commission is of the opinion that any revisions required as a result of the operation of a trigger event should be delayed in the same manner as that set out in section 13.4.3.

One problem with expanding the application of the transitional arrangements to trigger events is that the delay would not be captured by rule 92(3) because this rule only applies to delays between:

- the revision commencement date specified in an access arrangement; and
- the date that the revisions actually take effect.

Given the potential for a trigger event to result in revisions commencing before the commencement date specified in an access arrangement, rule 92(3) cannot, in its current form, be relied upon to deal with delays of this nature. An additional transitional provision is therefore required to address this gap. The precise form that this provision takes is outlined in section 13.5.1, but in short it will expand the definition of the term 'interval of delay' to include delays of this nature.

572 *Application by WA Gas Networks Pty Ltd (No. 3)* [2012] ACompT 12, paras 204-221.

573 The effect that a trigger mechanism may have on the review submission date specified in an access arrangement is set out in rule 51(1) of the NGR. In accordance with this rule, the review submission date specified in an access arrangement may advance to an earlier date if the arrangement includes a trigger mechanism and the trigger event occurs.

Finally, it is worth noting that the trigger event issue is unique to the Goldfields Gas Pipeline because the Mid-West and South-West Gas Distribution System access arrangement does not have a defined trigger event. This element of the transitional provisions therefore only applies to the Goldfields Gas Pipeline.

Summary

To summarise, under the revised transitional arrangements outlined above, the following will occur:

- ATCO Gas will be permitted to submit the Mid-West and South-West Gas Distribution System access arrangement revision proposal to the ERA up to three months after the ERA finalises the rate of return guidelines;
- APA Group will be permitted to submit the Goldfields Gas Pipeline access arrangement revisions proposal to the ERA up to six months after the ERA finalises the rate of return guidelines. The requirement to submit within this period extends to any revisions required as a result of the operation of a trigger mechanism in the current access arrangement; and
- delays in the commencement of revisions will either be dealt with under rule 92(3) or the transitional provision pertaining to trigger event related delays.

13.4.5 Overall assessment of the revised transitional arrangements

To assess the overall consistency of the revised transitional arrangements with the NGO and the RPP, the Commission has had regard to the principles set out in section 3.6. The Commission's findings can be summarised as follows:

- *Principle 1: final rules to apply as soon as possible* - The revised arrangements will enable the new rule to be applied to both ATCO Gas and APA Group during the next access arrangement review process. The revised arrangements may therefore be viewed as being consistent with this principle.
- *Principle 2: sufficient time for consultation* - The revised arrangements will have no effect on the level of stakeholder consultation already provided for in the access arrangement review process. They will, however, enable greater participation by interested parties in the rate of return guideline development process. The revised arrangements may therefore be viewed as being consistent with this principle.
- *Principle 3: opportunity to recover at least efficient costs* - The revised arrangements will have no effect on the opportunity that ATCO Gas or APA Group will have to recover at least efficient costs. The revised arrangements may therefore be viewed as being consistent with this principle.
- *Principle 4: arrangements practicable having regard to stakeholders' resourcing constraints* - The revised arrangements may place some additional resourcing pressure on the ERA in early 2015 because there will be an overlap between the

Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline access arrangement review processes. However, the ERA has informed the Commission that the proposed arrangements are workable.

- *Principle 5: minimising price volatility* - The revised arrangements will have no obvious effect on price volatility because if there is any delay in the commencement of revisions:
  - the existing reference tariffs will continue to operate; and
  - any true-up that may be required should be carried out in NPV neutral terms and smoothed over the remaining term of the new access arrangement period.

It follows from this assessment that, in the Commission's opinion, the revised arrangements are consistent with the principles set out in section 3.6, and the NGO and RPP, more generally.

13.5 Guidance

To give effect to the transitional arrangements outlined in the preceding section, the transitional provisions provide for:

- the AER and the ERA to publish final rate of return guidelines by 29 November 2013 and to issue a statement by 21 December 2012 setting out:
  - the proposed schedule, including milestones and dates, for the rate of return guidelines; and
  - the specific consultation procedure to be followed for the rate of return guidelines, which must be consistent with the rate of return consultative procedures.
- the postponement of the Mid-West and South-West Gas Distribution System and Goldfields Gas Pipeline review submission dates; and
- the application of rule 92(3), in cases where there is a delay between the date that trigger event related revisions should have taken effect and the date the revisions actually come into effect.

Further detail on the transitional provisions that have been put in place to give effect to the latter two of these matters is set out below.

13.5.1 Postponement of review submission dates

In its current form, rule 52 states that a service provider must, on or before the revision submission date, submit an access arrangement revision to the regulator. The period for submitting an access arrangement may be extended under rule 52(3), but this rule only provides for a two month extension. To enable the Mid-West and South-West Gas

Distribution System and Goldfields Gas Pipeline review submission dates to be delayed for the required period, the transitional provisions:

- modify rule 52(3) to allow the ERA to extend the period for submitting an access arrangement revision proposal by up to 18 months;[574] and
- require the ERA to exercise its power under the modified rule to extend the Mid-West and South-West Gas Distribution System (Goldfields Gas Pipeline) period for submission to a date that is no later than three (six) months after the rate of final return guidelines are published.

13.5.2 Delays to trigger event related revisions

Rule 92(3) currently states that if there is a delay between the revisions commencement date specified in an access arrangement and the date the revisions actually take effect:

- the reference tariffs prevailing at the end of the previous access arrangement period will continue without variation for the interval of delay; and
- the delay may be taken into account when fixing reference tariffs for the new access arrangement period.

The definition of 'interval of delay' in rule 92(3) does not currently capture delays between the date revisions should have taken effect as a result of the operation of the trigger mechanism and the date the revisions actually come into effect. A transitional provision is therefore required to overcome this gap.

To ensure that rule 92(3) can be applied if a trigger event under the Goldfields Gas Pipeline access arrangement causes the revision submission date to advance, the transitional provisions will define the term 'interval of delay', for the purposes of rule 92(3), as:

> "'the period between the date that is 12 months after the date that the review *submission date* advances to, by virtue of the operation of rule 51(1) and that access arrangement, and the date on which revisions to the access arrangement actually commence.'"

574 An 18 month period has been referred to in this transitional rule to accommodate the trigger event provisions specified in the Goldfields Gas Pipeline access arrangement, which could occur at any time in the lead up to the review submission date specified in this access arrangement.

Abbreviations

ACT	Australian Competition Tribunal
AEMC or Commission	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
APIA	Australian Pipeline Industry Association
ARR	annual revenue requirement
ATA	Alternative Technology Association
Brattle	The Brattle Group
capex	capital expenditure
CAPM	Capital Asset Pricing Model
CPA	Competition Principles Agreement
DBP	Dampier Bunbury Pipeline
DNSP	distribution network service provider
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ENA	Energy Networks Association
ERA	Economic Regulator Authority
ESAA	Energy Supply Association of Australia
ESCV	Essential Services Commission of Victoria
ETNOF	Electricity Transmission Network Owners Forum
EUAA	Energy Users Association of Australia
EURCC	Energy Users Rule Change Committee
FIG	Financial Investor Group

IPART	Independent Pricing and Regulatory Tribunal
LMR	Limited Merits Review
MAR	maximum allowed revenue
MCE	Ministerial Council on Energy
MEU	Major Energy Users
NBN	National Broadband Network
NEL	National Electricity Law
NEM	National Electricity Market
NEO	national electricity objective
NER	National Electricity Rules
NGL	National Gas Law
NGO	national gas objective
NGR	National Gas Rules
NPV	net present value
NSP	network service provider
NSW T-Corp	NSW Treasury Corporation
OEB	Ontario Energy Board
opex	operating expenditure
PTRM	post-tax revenue model
QTC	Queensland Treasury Corporation
RAB	regulatory asset base
RIIO	Revenue = Incentives + Innovation + Outputs
RIN	Regulatory Information Notice
RIPUC	Rhode Island Public Utilities Commission
RIT-D	Regulatory Investment Test for Distribution

RIT-T	Regulatory Investment Test for Transmission
RPP	Revenue and Pricing Principles
SCER	Standing Council on Energy and Resources
SCO	Standing Committee of Officials
SFG	Strategic Finance Group Consulting
SORI	Statement of Regulatory Intent
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
UE and MG	United Energy and MultiNet Gas
Victorian DPI	Victorian Department of Primary Industries
WACC	Weighted Average Cost of Capital

A Detailed examples of potential capex sharing schemes

This appendix includes a non-exhaustive list of possible ways in which the AER might design a capex sharing scheme under the draft rules.[575]

Figure A.1 below presents two different models: Model 1 presents a stylised example similar to that provided by the ENA's consultants of a capex efficiency carry-over scheme with a five year carry-over period using a WACC of 7.5%; Model 2 presents a stylised example of the ex-ante or fixed incentive rate scheme previously used by Ofgem.

Figure A.1 Examples of efficiency carryover scheme and ex ante incentive rate scheme with periodic true-up

Model 1: ESC "capex efficiency carry over" scheme										
Year	1	2	3	4	5	6	7	8	9	10
Forecast capex	300	330	270	300	330					
Actual capex	280	310	300	290	320					
Underspend	20	20	-30	10	10					
Annual financing benefit	1.50	1.50	-2.25	0.75	0.75					
Year 1 benefit	1.50	1.50	1.50	1.50	1.50					
Year 2 benefit		1.50	1.50	1.50	1.50	1.50				
Year 3 benefit			-2.25	-2.25	-2.25	-2.25	-2.25			
Year 4 benefit				0.75	0.75	0.75	0.75	0.75		
Year 5 benefit					0.75	0.75	0.75	0.75	0.75	
Benefit / Carry over	1.50	3.00	0.75	1.50	2.25	0.75	-0.75	1.50	0.75	0.00
Discount factor (to end of year 5)	1.38	1.29	1.20	1.11	1.04	0.96	0.90	0.83	0.78	0.72
Total benefits (PV at end year 5)	39.02									
DB benefits (PV at end year 5))	12.73									
Incentive rate	32.62%									

Model 2: Ex-ante incentive rate with true-up at start of regulatory period					
Annual underspend	20	20	-30	10	10
Total Benefits (PV at end year 5)	39.02				
Target share of underspend (PV at end year 5)	12.73				
Benefit already received					
Cumulative underspend	20	40	10	20	30
Financing benefit from underspending	1.5	3	0.75	1.5	2.25
Total benefit already received (PV at end year	10.84				
Additional benefit required (PV at end year 5)	1.88				
Realised incentive rate	32.62%				

In the Model 1 scheme, the business has a total underspend across the five years of $30 million in nominal terms. This has a present value of $39 million at the end of year 5. In keeping with earlier Australian schemes the benefit to the business is taken to be the financing cost forgone from having underspent the capex allowance contained in the allowed revenue requirement. This has a present value of $12.7 million (at the end of year 5) leading to the business retaining 32.6 per cent of the available benefit.

The Model 2 scheme is designed to achieve the same incentive rate as that obtained from Model 1, namely 32.6 per cent, for illustrative purposes. Again, the NSP obtains a financing benefit from having underspent its capex allowance although in this case that only goes through to the end of the current regulatory period. Again the present value of the underspend is $39 million (at the end of year 5) and the NSP receives a financing benefit of $10.8 million through to the end of the regulatory period. To achieve the specified incentive rate of 32.6 per cent the NSP requires total benefits of $12.7 million in present value terms (at the end of year 5) meaning an additional benefit of $1.9 million will have to be given to the NSP in the form of additional allowed revenue requirement at the start of the next regulatory period.

575 These examples have been developed with advice from Economic Insights.

Figure A.2 provides a stylised example of how a scheme involving an annual true up of efficiency gains and losses (as Ofgem plans to use) might work (Model 3).

Figure A.2 Example of ex ante incentive rate scheme with lagged annual true-up

Model 3: Ex-ante incentive rate with annual lagged true-up

Year	1	2	3	4	5	6	7	8	9	10
Forecast capex	300	330	270	300	330					
Actual capex	280	310	300	290	320					
Underspend	20	20	-30	10	10					
Year 1 effect										
Underspend	20									
Total Benefits (PV at end year 2)	22.29									
DB's target share of benefit	7.27									
Benefit already received										
Financing benefit from underspending	1.50									
Benefit already received (PV at end year 2)	1.67									
Additional benefit required (PV at end year 2)	5.60									
Year 2 effect										
Underspend		20								
Total Benefits (PV at end year 3)		22.29								
DB's target share of benefit		7.27								
Benefit already received										
Financing benefit from underspending		1.50								
Benefit already received (PV at end year 3)		1.67								
Additional benefit required (PV at end year 3)		5.60								
Year 3 effect										
Underspend			-30							
Total Benefits (PV at end year 4)			-33.44							
DB's target share of benefit			-10.91							
Benefit already received										
Financing benefit from underspending			-2.25							
Benefit already received (PV at end year 4)			-2.51							
Additional benefit required (PV at end year 4)			-8.40							
Year 4 effect										
Underspend				10						
Total Benefits (PV at end year 5)				11.15						
DB's target share of benefit				3.64						
Benefit already received										
Financing benefit from underspending				0.75						
Benefit already received (PV at end year 5)				0.84						
Additional benefit required (PV at end year 5)				2.80						
Year 5 effect										
Underspend					10					
Total Benefits (PV at end year 6)					11.15					
DB's target share of benefit					3.64					
Benefit already received										
Financing benefit from underspending					0.75					
Benefit already received (PV at end year 6)					0.84					
Additional benefit required (PV at end year 6)					2.80					
Summary										
Financing benefits (nominal)			1.67	1.67	-2.51	0.84	0.84			
Financing benefits (PV at end year 5)			2.08	1.93	-2.70	0.84	0.78			
Total financing benefits (PV at end year 5)						2.93				
Additional benefits required (nominal)			5.60	5.60	-8.40	2.80	2.80			
Additional benefits required (PV at end year 5)			6.96	6.47	-9.03	2.80	2.60			
Total additional benefits required (PV at end						9.80				
Total DB benefits (PV at end year 5)						12.73				
Realised incentive rate						32.62%				

Again the same data as used in Models 1 and 2 are used and the same ex–ante incentive rate of 32.6 per cent is chosen for illustrative purposes. The underspend from year 1 is now trued–up at the start of year 3 and so on leading to the year 5 underspend being trued–up at the start of year 7. The NSP now effectively only retains one year of financing benefits on a rolling basis through the regulatory period. In Model 3 the year 1 true–up is done at the start of year 3 in present value terms at the end of year 2, the year 2 true–up is done at the start of year 4 in present value terms at the end of year 3 and so on.

Converting the smaller financing benefits to present values terms at the end of year 5 for comparison with Model 2, the NSP has retained benefits of $2.9 million out to year 7. Converting the larger additional benefits required series to present value terms at the end of year 5, the NSP requires additional revenue of $9.8 million (delivered in a series of annual revenue requirement additions in years 3 through to 7) to achieve the specified ex–ante incentive rate.

The main difference between Models 2 and 3 is that the periodic true–up in Model 2 allows the financing benefit to make up most of the NSP's overall benefit whereas the lagged annual true–up in Model 3 requires most of the NSP benefit to come from additional allowances.

B Sample of contingent projects and indicative costs

Below are samples of transmission contingent projects and their anticipated values which were accepted by the AER in recent transmission regulatory determinations. These were considered as part of the Commission's analysis on establishing an appropriate threshold for distribution and transmission contingent projects.

Table B.1 Contingent projects and indicative costs

TNSP	Regulatory period	Project	Cost	Unit	Triggered
Powerlink	2012/13 to 2016/17	Galilee Basin connection shared network works	88.4	$m, 2011-12	No
		Moranbah area	54.9		No
		Bowen industrial estate	80.7		No
		Callide to Moura transmission line and Calvale transformer	50.8		No
		Gladstone state development area	115.7		No
		Ebenezer establishment	62.7		No
		QNI upgrade	60.6		No
		Western Downs to Columboola 275kV 3rd circuit	59.5		No
		Columboola to Wandoan South 275kV 3rd circuit	63.3		No
		Halys to Blackwall 500kV operating at 275kV,	148.9		No
		Halys to Western Downs, 3rd and 4th circuits, 500kV operating at 275kV	261.4		No
		Halys to Greenbank, 3rd and 4th circuits, 500kV operating at 275kV	149.2		No
Transend	2009/10 to 2013/14	Sheffield–George Town new transmission line	70	$m, 2007-08	No
		Burnie–Smithton new transmission line	88		No
		Sheffield–Farrell new transmission line	79		No

TNSP	Regulatory period	Project	Cost	Unit	Triggered
		Sheffield–Burnie new transmission line	52		No
		St Helens new 110/22 kV connection site	46		No
		Palmerston– Sheffield 220 kV transmission line augmentation	22		No
		Waddamana–Lindisfarne 220 kV transmission line second circuit	22		No
		Trevallyn Substation new 220/110 kV injection point	21		No
		Queenstown Substation security upgrade	11		No
TransGrid	2009/10 to 2013/14	Kemps Creek−Liverpool 330 kV line—undergrounding of all or part of the proposed connection	108	$m, 2007-08	No
		Hunter Valley–Central Coast 500 kV line	300		No
		Darlington−Balranald system upgrade 275 kV	51		No
		Yass to Wagga 500 kV double circuit transmission line	329		No
		Liddell−Tamworth 330 kV	163		No
		Tamworth−Armidale 330 kV line	130		No
		Bannaby−Yass reinforcement	45		No
		Williamsdale–Cooma 3rd circuit	40		No
		New 500/330 kV substation at Richmond Vale	80		No
		CBD and inner metropolitan area supply	342		No
		Gadara/Tumut load area support	54		No
		Orange 330/132 kV substation	47		No
		Victorian interconnector development	35		No

TNSP	Regulatory period	Project	Cost	Unit	Triggered
		QNI upgrade—line series compensation project	60		No
		Reactive support at seven sites	36		No
ElectraNet	2008/09 to 2012/13	Eyre Peninsula reinforcement	150	$m	No
		Riverland reinforcement	130		No
		Yorke Peninsula reinforcement	41		No
		South East reinforcement	33		No
		Bungama reinforcement	12		No
		Southern Suburbs reinforcement	16		No
		Playford (Davenport) to Leigh Creek 132 kV transmission line	11[576]		
		Fleurieu Peninsula reinforcement	65		No
		Murray Mallee reinforcement	34		No
		Munno Para reinforcement	26		Approved $39.3 ($m, 2007/08) on 11 March 2011
		Lucindale West reinforcement	17		No
		Western Suburbs reinforcement	15		No
		Tailem Bend to Tungkillo reinforcement	41		No
		Parafield Gardens West	14		No
		Para – Brinkworth – Davenport 275 kV transmission lines	12		No
		Heywood interconnection capacity upgrade	80		No
		Northern transmission reinforcement	75		No

576 Five per cent of the MAR is $11m, which makes this amount the cost threshold for ElectraNet's contingent projects.

TNSP	Regulatory period	Project	Cost	Unit	Triggered
		Adelaide CBD line works component	105		Approved $131.38 ($m, nominal) on 1 November 2009
		Transformer ballistic proofing	17		No

Source: AER final decision, ElectraNet transmission determination 2008-09 to 2012-13, 11 April 2008, p. 61; AER final decision, Powerlink transmission determination 2012-13 to 2016-17, April 2012, p. 45; AER final decision, Transend transmission determination 2009-10 to 2013-14, 28 April 2009, pp. 55-57; AER final decision, TransGrid transmission determination 2009-10 to 2013-14, 28 April 2009, p. 43.