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Legal opinion

Confidential

To
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From
The Hon. John Middleton AM KC
Senior Advisor

Our reference
BRE/BRE

Date
26 November 2025

The question

1 AusNet Electricity Services Pty Ltd (**AusNet**), Jemena Electricity Networks (Vic) Ltd (**Jemena**), Powercor Australia Ltd (**Powercor**) and United Energy Distribution Pty Ltd (**United Energy**), (together, the **Victorian DNSPs**) are subject to economic regulation under Chapter 6 of the National Electricity Rules (**NER**).

2 The Victorian DNSPs are currently undergoing their 'regulatory resets' for the regulatory control period (**RCP**) commencing on 1 July 2026 and ending on 30 June 2031 (**2026 – 2031 RCP**). The Australian Energy Regulator (**AER**) has recently released its draft decisions on each DNSP's distribution determination for the RCP (**Draft Decisions**). As part of its Draft Decisions, the AER has set out its proposed approach to each of the Victorian DNSPs':

2.1 operating expenditure (**opex**), including insurance-related opex, for the 2026 – 2031 RCP; and

2.2 revenue increments and decrements for the 2026 – 2031 RCP, arising from the application of the efficiency benefit sharing scheme (**EBSS**) to the DNSP's opex in the 2021 – 2026 RCP (**EBSS carryover amounts**).

3 The Victorian DNSPs are concerned with the AER's approach to assessing their insurance-related opex and EBSS carryover amounts. In its Draft Decisions, the AER made three adjustments that relate to each of the Victorian DNSPs' insurance costs, as follows:

3.1 a non-recurrent cost adjustment included in base year opex, which increases each of the Victorian DNSPs' opex allowances in each year of the 2026 – 2031 RCP (referred to by the AER as a 'base year non-recurrent efficiency gain'), which it says is in an amount equal to

the DNSP's underspend on insurance premiums in the base year (e.g. insurance premiums forecast in the base year less actual insurance premiums in that year);[1]

3.2 a negative step change adjustment, calculated as the difference between the premium allowance and actual premium in the final year, that decreases each of the Victorian DNSPs' opex allowances in each year of the 2026 – 2031 RCP;[2] and

3.3 an adjustment to the calculation of the EBSS carryover amounts arising from the application of the EBSS during the 2021 – 2026 RCP, to reflect the non-recurrent efficiency gain adjustment made to base year opex in forecasting opex for the 2026 – 2031 RCP.

4 The Victorian DNSPs have asked for a legal opinion as to the legality of the AER's three-step approach to determining opex and EBSS carryover amounts for the 2026 – 2031 RCP.

Summary of opinion

5 The AER's Draft Decisions, which treat the Victorian DNSPs' underspends on insurance premiums in the 2026 – 2031 RCP as non-recurrent efficiency gains, are not authorised by any statutory provision. In other words, the AER does not have the power to make the adjustments set out in its Draft Decisions.

6 The AER's Draft Decisions, which effect a clawback of the Victorian DNSPs' underspend on insurance premiums in the 2021 – 2026 RCP (and indeed, penalise the Victorian DNSPs for the underspend), are contrary to the scheme of Chapter 6 of the National Electricity Rules (**NER**).

7 The AER's Draft Decisions contravene section 16(1) of the National Electricity Law (**NEL**). The AER is not exercising its economic regulatory function or power in a manner that will or is likely to contribute to the achievement of the National Electricity Objective (**NEO**).

8 The reasoning of, and rationale for, the AER's Draft Decisions are unreasonable.

The legal framework

9 The legal framework governing the making of the AER's Draft Decisions is primarily contained in the NEL and Chapter 6 of the NER.

10 Economic efficiency is the keystone to the regulation of the Victorian DNSPs, as can be seen by the legal framework governing the role of the AER.

Relevant NEL provisions

11 When making a distribution determination, the AER is required to do so in a manner that will, or is likely to, contribute to the achievement of the national electricity objective (**NEO**).[3] The NEO is (relevantly):[4]

> *…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:*

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1 The AER's precise wording differs between the Draft Decisions for each of the Victorian DNSPs. This statement is from: AER, *Attachment 3 – Operating Expenditure – Draft Decision – Jemena distribution determination 2026 – 2031,* 30 September 2025, at p. 4; AER, *Attachment 3 – Operating Expenditure – Draft Decision – AusNet distribution determination 2026 – 2031,* 30 September 2025, at p. 4.

2 The AER's precise wording differs between the Draft Decisions for each of the Victorian DNSPs. This statement is from: AER, *Attachment 3 – Operating Expenditure – Draft Decision – Powercor distribution determination 2026 – 2031,* 30 September 2025, at p. 35; AER, *Attachment 3 – Operating Expenditure – Draft Decision – United Energy distribution determination 2026 – 2031,* 30 September 2025, at p. 4.

3 *National Electricity Law,* section 16(1)(a). This section requires the AER to exercise an AER economic regulatory function or power in the manner described above. The 'AER economic regulatory functions or powers' are defined in section 2 of the NEL to include a function or power that relates to the making of a distribution determination.

4 *National Electricity Law,* section 7 (own emphasis added).

(a) price, quality, safety and reliability and security of supply of electricity; and

(b) the reliability, safety and security of the national electricity system…

12 The NEL also provides that the AER, when exercising a discretion in making those parts of a distribution determination relating to direct control network services, must take into account the revenue and pricing principles.[5] The revenue and pricing principles are set out in section 7A of the NEL and relevantly include:[6]

> *(2) A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in–*
>
> *(a) providing direct control network services; and*
>
> *(b) complying with a regulatory obligation or requirement or making a regulatory payment.*
>
> *(3) A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes–*
>
> *(a) efficient investment in a distribution system … with which the operator provides direct control network services; and*
>
> *(b) the efficient provision of electricity network services; and*
>
> *(c) the efficient use of the distribution system … with which the operator provides direct control network services.*
>
> …
>
> (5) *A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.*

13 The NEO and the revenue and pricing principles are complementary and operate together; the long-term interests of consumers are served by the recovery by service providers of at least their efficient costs. A decision which is inconsistent with the revenue and pricing principles cannot be a decision that will, or is likely to, contribute to the achievement of the NEO. This has been recognised by the Australian Competition Tribunal on numerous occasions, one example being in *Re Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3.[7]

Relevant NER provisions

14 Clause 6.2.4 of the NER provides that the AER must make a distribution determination for each DNSP, following the process in Part E of Chapter 6 of the NER. This process includes the submission by each DNSP of a regulatory proposal. Clause 6.8.2 of the NER provides that a DNSP's regulatory proposal must include, for direct control services, a 'building block proposal'. The building block proposal is a key part of the AER's making of a 'building block determination'.[8]

15 A building block determination is a determination by the AER that relevantly specifies for a DNSP, for a regulatory control period:[9]

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5 *National Electricity Law,* section 16(2)(a).

6 *National Electricity Law,* section 7A (own emphasis added).

7 *Re Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3 at [15].

8 *National Electricity Rules*, clause 6.3.1.

9 *National Electricity Rules*, clause 6.3.2(1).

(1) the *Distribution Network Service Provider's annual revenue requirement* for each *regulatory year* of the *regulatory control period*;

…

(3) how any *applicable efficiency benefit sharing scheme, service target performance incentive scheme*, or *demand management incentive scheme* are to apply to the Distribution Network Service Provider;

16 Clause 6.4.3 of the NER sets out the 'building block approach', to be used by the AER when determining a DNSP's annual revenue requirement. Relevant provisions of clause 6.4.3 are set out below, relating to opex, incentive schemes, and revenue increments or decrements.

6.4.3 Building block approach

(a) **Building blocks generally**

The *annual revenue requirement* for a *Distribution Network Service Provider* for each *regulatory year* of a *regulatory control period* must be determined using a building block approach, under which the building blocks are:

…

(5) the revenue increments or decrements (if any) for that year arising from the application of any *efficiency benefit sharing scheme*, *capital expenditure sharing scheme*, *service target performance incentive scheme*, *demand management incentive scheme*, *demand management innovation allowance mechanism* or *small-scale incentive scheme* – see subparagraph (b)(5);

(6) the other revenue increments or decrements (if any) for that year arising from the application of a control mechanism in the previous *regulatory control period* – see paragraph (b)(6);

…

(7) the forecast operating expenditure for that year – see paragraph (b)(7).

(b) **Details of the building blocks**

For the purposes of paragraph (a):

…

(5) the revenue increments or decrements referred to in subparagraph (a)(5) are those that arise as a result of the operation of an applicable *efficiency benefit sharing scheme*, *capital expenditure sharing scheme*, *service target performance incentive scheme*, *demand management incentive scheme*, *demand management innovation allowance mechanism* or *small-scale incentive scheme* as referred to in clauses 6.5.8, 6.5.8A, 6.6.2, 6.6.3, 6.6.3A and 6.6.4;

(6) the other revenue increments or decrements referred to in paragraph (a)(6) are those that are to be carried forward to the current *regulatory control period* as a result of the application of a control mechanism in the previous *regulatory control period* and are apportioned to the relevant year under the distribution determination for the current *regulatory control period*;

…

(7) the forecast operating expenditure for the year is the forecast operating expenditure as accepted or substituted by the *AER* in accordance with clause 6.5.6.

17 As discussed above, the relevant 'building blocks' for present purposes are those relating to forecast opex and incentive schemes (specifically, the EBSS). Clause 6.5.6 of the NER governs the inclusion of opex in a DNSP's distribution determination. Clause 6.5.6 is set out below.

6.5.6 Forecast operating expenditure

(a) A *building block proposal* must include the total forecast operating expenditure for the relevant *regulatory control period* which the *Distribution Network Service Provider* considers is required in order to do each of the following (the *operating expenditure objectives*):

(1) meet or manage the expected demand for *standard control services* over that period;

(2) comply with all applicable *regulatory obligations or requirements* associated with the provision of *standard control services*;

(3) to the extent that there is no applicable *regulatory obligation or requirement* in relation to:

(i) the quality, reliability or security of supply of *standard control services*; or

(ii) the reliability or security of the *distribution system* through the supply of *standard control services*,

to the relevant extent:

(iii) maintain the quality, reliability and security of supply of *standard control services*; and

(iv) maintain the reliability and security of the *distribution system* through the supply of *standard control services*;

(4) maintain the safety of the *distribution system* through the supply of *standard control services*; and

(5) contribute to achieving *emissions reduction targets* through the supply of *standard control services*.

(b) The forecast of required operating expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* must:

(1) comply with the requirements of any relevant *regulatory information instrument*;

(2) be for expenditure that is properly allocated to *standard control services* in accordance with the principles and policies set out in the *Cost Allocation Method* for the *Distribution Network Service Provider*; and

(3) include both:

(i) the total of the forecast operating expenditure for the relevant *regulatory control period*; and

(ii) the forecast operating expenditure for each *regulatory year* of the relevant *regulatory control period*.

(c) The *AER* must accept the forecast of required operating expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* if the *AER* is satisfied that the total of the forecast operating expenditure for the *regulatory control period* reasonably reflects each of the following (the *operating expenditure criteria*):

(1) the efficient costs of achieving the *operating expenditure objectives*; and

(2) the costs that a prudent operator would require to achieve the *operating expenditure objectives*; and

(3) a realistic expectation of the demand forecast, cost inputs and other relevant inputs required to achieve the *operating expenditure objectives*.

(d) If the *AER* is not satisfied as referred to in paragraph (c), it must not accept the forecast of required operating expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal*.

(e) In deciding whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the *operating expenditure factors*):

(1) the most recent *annual benchmarking report* that has been *published* under rule 6.27 and the benchmark operating expenditure that would be incurred by an efficient *Distribution Network Service Provider* over the relevant *regulatory control period*;

(2) the actual and expected operating expenditure of the *Distribution Network Service Provider* during any preceding *regulatory control periods*;

(3) the extent to which the operating expenditure forecast includes expenditure to address the concerns of *distribution service end users* as identified by the *Distribution Network Service Provider* in the course of its engagement with *distribution service end users* or groups representing them;

(4) the extent to which the operating expenditure forecast would efficiently reduce the risk and impact on consumers of power outages caused by severe weather events;

(5) the relative prices of operating and capital inputs;

(6) the substitution possibilities between operating and capital expenditure;

(7) whether the operating expenditure forecast is consistent with any incentive scheme or schemes that apply to the Distribution Network Service Provider under clauses 6.5.8 or 6.6.2 to 6.6.4;

(8) the extent the operating expenditure forecast is referable to arrangements with a person other than the Distribution Network Service Provider that, in the opinion of the AER, do not reflect arm's length terms;

(9) whether the operating expenditure forecast includes an amount relating to a project that should more appropriately be included as a contingent project under clause 6.6A.1(b);

(10) the extent the Distribution Network Service Provider has considered, and made provision for, efficient and prudent non-network options or SAPS options;

(11) any relevant final project assessment report published under clause 5.17.4(o), (p) or (s); and

(12) any other factor the AER considers relevant and which the AER has notified the Distribution Network Service Provider in writing, prior to the submission of its revised regulatory proposal under clause 6.10.3, is an operating expenditure factor.

18 Clause 6.5.8 governs the EBSS. Clause 6.5.8 is set out below.

6.5.8 Efficiency benefit sharing scheme

(a) The *AER* must, in accordance with the *distribution consultation procedures*, develop and *publish* an incentive scheme or schemes (*efficiency benefit sharing scheme*) that provide for a fair sharing between *Distribution Network Service Providers* and *Distribution Network Users* of:

(1) the efficiency gains derived from the operating expenditure of *Distribution Network Service Providers* for a *regulatory control period* being less than; and

(2) the efficiency losses derived from the operating expenditure of *Distribution Network Service Providers* for a *regulatory control period* being more than, the forecast operating expenditure accepted or substituted by the *AER* for that *regulatory control period*.

(b) An *efficiency benefit sharing scheme* may (but is not required to) be developed to cover efficiency gains and losses related to *distribution losses*.

(c) In developing and implementing an *efficiency benefit sharing scheme*, the *AER* must have regard to:

(1) the need to ensure that benefits to *distribution service end users* likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for *Distribution Network Service Providers*;

(2) the need to provide *Distribution Network Service Providers* with a continuous incentive, so far as is consistent with economic efficiency, to reduce operating expenditure;

(3) the desirability of both rewarding *Distribution Network Service Providers* for efficiency gains and penalising *Distribution Network Service Providers* for efficiency losses;

(4) any incentives that *Distribution Network Service Providers* may have to capitalise expenditure; and

(5) the possible effects of the scheme on incentives for the implementation of *non-network options* or *SAPS options*.

(d) The *AER* may, from time to time and in accordance with the *distribution consultation procedures*, amend or replace an *efficiency benefit sharing scheme*.

19 A distribution determination is predicated on the AER's 'constituent' decisions, described in clause 6.12.1 of the NER. Relevantly, these constituent decisions include:

(d) a decision in which the *AER* either:

(1) acting in accordance with clause 6.5.6(c), accepts the total of the forecast operating expenditure for the *regulatory control period* that is included in the current *building block proposal*; or

(2) acting in accordance with clause 6.5.6(d), does not accept the total of the forecast operating expenditure for the *regulatory control period* that is included in the current *building block proposal*, in which case the *AER* must set out its reasons for that decision and an estimate of the total of the *Distribution Network Service Provider's* required operating expenditure for the *regulatory control period* that the *AER* is satisfied reasonably reflects the *operating expenditure criteria,* taking into account the *operating expenditure factors;*

…

(i) a decision on how any applicable *efficiency benefit sharing scheme, capital expenditure sharing scheme, service target performance incentive scheme, demand management incentive scheme, demand management innovation allowance mechanism* or small-*scale incentive scheme* is to apply to the *Distribution Network Service Provider*;

(j) a decision in which the *AER* decides other appropriate amounts, values or inputs;

…

AER approach to assessing opex

20 In accordance with clause 6.4.5 of the NER, the AER has published the *Expenditure Forecast Assessment Guideline for Electricity Distribution* dated October 2024 (**Expenditure Forecast Assessment Guideline**), which sets out (among other things) the AER's general approach to assessing a DNSP's proposed opex forecast for the purposes of clause 6.5.6 of the NER.

21 The AER generally applies a 'base-step-trend' approach to forecasting opex, under which: [10]

21.1 *'base'* - actual opex incurred in a recent year (referred to respectively as 'base opex' and the 'base year') is adopted as a starting point (provided the AER is satisfied that the base opex is efficient and prudent), and adjusted to provide an estimate of opex for the final year of the RCP, address any non-recurring opex and exclude any actual opex for opex categories for which opex is forecast or recovered in another manner. This approach is referred to as the 'revealed cost' approach;

21.2 *'trend'* - the estimated final year opex is then 'trended' forward to the upcoming RCP by applying the 'rate of change' to account for the forecast growth in output, prices and productivity; and

21.3 *'step'* - step changes in prudent and efficient opex, resulting from drivers such as changes in regulatory obligations or efficient capital expenditure (**capex**)/opex trade-offs, are then included in the opex forecast.

22 In respect of step changes, the AER observes, in the Expenditure Forecast Assessment Guideline (at pages 9-10):

> Our approach is to separately assess the prudence and efficiency of forecast cost increases or decreases associated with new regulatory obligations and capex/opex trade-offs. For capex/opex trade-off step changes, we will assess whether it is prudent and efficient to substitute capex for opex or vice versa.
>
> …
>
> We will not allow step changes for any short-term cost to the DNSP of implementing efficiency improvements in expectation of being rewarded through expenditure incentive mechanisms such as the EBSS. We expect DNSPs to bear such costs and thereby make efficient trade-offs between bearing these costs and achieving future efficiencies.

23 The AER further observes (at pages 24-25):

> Step changes may be added (or subtracted) for any other costs not captured in base opex or the rate of change that are required for forecast opex to meet the opex criteria. We will assess step changes in accordance with section 2.2 above. Step changes should not double count costs included in other elements of the opex forecast:
>
> • Step changes should not double count the costs of increased volume or scale compensated through the output measure in the rate of change.

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10 AER, *Expenditure Forecast Assessment Guideline for Electricity Distribution*, at p, 22.

- Step changes should not double count the cost of increased regulatory burden over time, which forecast productivity growth may already account for. We will only approve step changes in costs if they demonstrably do not reflect the historic 'average' change in costs associated with regulatory obligations. We will consider what might constitute a compensable step change at resets, but our starting position is that only exceptional events are likely to require explicit compensation as step changes. Similarly, forecast productivity growth may also account for the cost increases associated with good industry practice.

- Step changes should not double count the costs of discretionary changes in inputs. Efficient discretionary changes in inputs (not required to increase output) should normally have a net negative impact on expenditure.

If it is efficient to substitute capex with opex, a step change may be included for these costs (capex/opex trade-offs).

24 When appropriate, however, the AER may assess some opex categories using other forecasting techniques, such as an efficient benchmark amount.[11]

The EBSS

25 The EBSS is an incentive scheme that provides for a fair sharing between DNSPs and distribution network users of:

25.1 the efficiency gains derived from the opex of DNSPs for a RCP being less than; and

25.2 the efficiency losses derived from the opex of DNSPs for a RCP being more than,

the forecast opex accepted or substituted by the AER for that RCP.

26 The EBSS is made by the AER pursuant to clause 6.5.8 of the NER. The latest version of the EBSS (version 2) was made by the AER in November 2013 (**Version 2 EBSS**).[12] The AER's Explanatory Statement for the Version 2 EBSS provides a useful summary of how, and why, the EBSS operates.[13]

27 The AER notes, in its Explanatory Statement, that:[14]

> The EBSS aims to provide a continuous incentive for NSPs to pursue efficiency improvements in opex and to share efficiency gains between NSPs and network users. It is intrinsically linked to our forecasting approach for opex. In our Expenditure Forecast Assessment Guidelines, we have stated our preference is to continue with the revealed cost base-step-trend forecasting approach for assessing opex. If a NSP has operated under an effective incentive framework, and sought to maximise its profits, the actual opex incurred in a base year should be a good indicator of the efficient opex required. However, we must test this, and if we determine a NSP's revealed costs are not efficient, we will adjust them to remove inefficient costs. We then add additional opex not reflected in the base year ('step changes') and trend it forward to reflect forecast changes in input costs, productivity and output growth.
>
> There are two potential incentive problems with this forecasting approach when an EBSS is not in place:
>
> 1. A NSP has an incentive to increase opex in the expected 'base year' to increase its forecast opex allowance for the following regulatory control period.

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11 As above.

12 AER, *Better Regulation, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013 (version 2).

13 AER, *Better Regulation, Explanatory Statement, Efficiency Benefit Sharing Scheme,* November 2013, at pp. 6 and 7.

14 AER, *Better Regulation, Explanatory Statement, Efficiency Benefit Sharing Scheme,* November 2013, at pp. 6 and 7.

2. A NSP's incentive to make sustainable change to its practices, and reduce its recurrent opex, declines as the regulatory control period progresses. It then increases again after the base year used to forecast opex for the following regulatory control period. By deferring these ongoing efficiency gains until after the base year the NSP can retain the benefits of doing so for longer because they won't be reflected in the opex forecasts for the following period.

We address these issues by applying an EBSS in combination with a revealed cost base-step-trend forecasting approach. This provides NSPs the same reward for an underspend and the same penalty for an overspend in each year of the regulatory control period.

The EBSS works as follows:

- The regulatory regime provides for ex ante opex forecasts. The NSP keeps the benefit (or incurs the cost) of delivering actual opex lower (higher) than forecast opex in each year of a regulatory control period.

- Prior to the start of the next regulatory control period, we calculate carryover amounts for opex efficiency gains or losses made in the regulatory control period. The NSP receives a carryover amount in each year so it retains incremental efficiency gains or losses for the length of the carryover period (usually five years) after it makes the gain or loss.

- We add the carryover amounts as an additional 'building block' when setting the NSP's regulated revenue for the next regulatory control period.

- The actual opex incurred in the base year is used as the starting point for forecasting opex in the next regulatory control period.

Under this approach, any increase or decrease in opex, relative to the allowance, is shared approximately 30:70 between NSPs and consumers.

28 When reviewing the EBSS in 2013, the AER observed that:[15]

> Where there are non-recurrent efficiency gains in the base year used to set the opex forecast, the opex forecast may not reflect the ongoing level of efficient opex by itself. However, the non-recurrent efficiency gains will lead to a positive EBSS carryover that will, in effect, compensate the NSP for the lower forecast.
>
> NSPs raised concerns that comparing their subsequent expenditure with their opex allowance could make them appear inefficient.

29 To address this issue, the AER "amended the EBSS to account for any adjustments made to base opex to remove the impacts of one-off factors".[16] The AER's approach, as reflected in the Version 2 EBSS, is described in the following extract from the Explanatory Statement.

> **2.2.1 Approach**
>
> We consider there should be flexibility in the EBSS to enable revenue to be shifted from the EBSS carryover to the opex allowance to account for non-recurrent efficiency gains in the base year.
>
> As a result, we have amended the EBSS to account for any adjustments made to base opex to remove the impacts of one-off factors.
>
> This is given effect through an amendment to the equation we will use to calculate the incremental efficiency gain in the final year:

15 AER, *Better Regulation, Explanatory Statement, Efficiency Benefit Sharing Scheme,* November 2013, at p. 20.

16 AER, *Better Regulation, Explanatory Statement, Efficiency Benefit Sharing Scheme,* November 2013, at p. 20.

$$I_{f,n} = \left(F_{f,n} - A^*_{f,n}\right) - \left(F_{f-1,n} - A_{f-1,n}\right)$$

Where:

$I_{f,n}$ is the marginal efficiency gain in the final year of period n

$F_{f,n}$ is forecast opex (subject to adjustments) in the final year of period n

$A^*_{f,n}$ is estimated actual opex in the final year of period n

$F_{f-1,n}$ is forecast opex (subject to adjustments) in the penultimate year of period n

$A_{f-1,n}$ is actual opex (subject to adjustments) in the penultimate year of period n.

The estimated actual opex for the final regulatory year will be calculated as:

$$A^*_{f,n} = F_{f,n} - \left(F_{b,n} - A_{b,n}\right) + \textit{non-recurrent efficiency gain}_{b,n}$$

Where:

b is the year of actual opex in period n used as the basis to set forecast opex for period $n+1$

$\textit{non-recurrent efficiency gain}_{b,n}$ is the adjustment made to base year opex used to forecast opex for period $n+1$ to account for opex associated with one-off factors.

This also requires the following amendment to the calculation of the incremental efficiency gain for the first year of the following period:

$$I_{1,n} = \left(F_{1,n} - A_{1,n}\right) - \left[\left(F_{f,n-1} - A_{f,n-1}\right) - \left(F_{b,n-1} - A_{b,n-1}\right)\right] - \textit{non-recurrent efficiency gain}_{b,n-1}$$

2.2.2 Reasons for approach

We have adopted this approach as a relatively simple and transparent method of taking account of efficiency gains occurring in the base year that will not persist into the future. It will minimise the rewards (penalties) for efficiency gains (losses) being carried forward by the opex forecast rather than the EBSS carryover payments.

Incenta Economic Consulting commented that, when testing the efficiency of a NSP's base year opex, it is important to ensure one-off factors do not impact the expenditure in the base year (and that adjustments are made if such one-off factors exist). If base year expenditure is significantly lower than ongoing efficient opex, due to a one-off factor, then the opex forecast for the next period would be artificially low. In this case a NSP would be sufficiently compensated through the EBSS carryover, but the 'optics' could be misleading. That is, a NSP's actual expenditure could appear high compared against its regulatory allowance (not factoring in the EBSS carryover).

We note that there are alternative approaches to dealing with the issue of one-off factors in the base year. The forecasting approach in the Expenditure Assessment Forecast Guideline allows some discretion in choosing the base year. Where the base year is not reflective of ongoing costs we can choose another, more reflective base year, if one is available. In the event one-off factors do impact expenditure in the proposed base year, this would be our preferred approach.

However, in the event a reflective base year is not available, we will adjust the base year to remove the impact of the one-off factor. We will make the commensurate adjustment to the EBSS carryover amounts by calculating the incremental gain in the final year in accordance with the final year equation

above. This would provide a similar revenue outcome to that which would be achieved if the actual base year (with the one-off factor) was used to set the opex forecast in combination with the unadjusted EBSS carryover amounts.

Box 2.2 Revenue impact of a base year one-off factor adjustment

Take the example of a NSP with an opex allowance of 100 dollars for each year of a five year regulatory control period. Its actual opex is as forecast in every year except the fourth year, when it spends 90 dollars due to a one-off factor. For simplicity assume there is no output, real price or productivity growth.

If we use the fourth year as the base year to forecast opex for the next regulatory control period, the forecast would be 90 dollars for each year of the next regulatory control period. Under the EBSS the NSP registers an incremental efficiency gain of 10 dollars in year four. The EBSS assumes the final or fifth year underspend is equal to the base year underspend. As a result, it registers no incremental gain/loss in year five. Thus the NSP would receive a 10 dollar carryover payment in the first four years of the next regulatory control period. Total opex revenue would be 450 dollars plus 40 dollars in EBSS carryovers.

However, say the one-off factor is identified and base opex is adjusted accordingly. Forecast opex would be 100 dollars for each year of the next regulatory control period. The EBSS registers an incremental efficiency gain of 10 dollars in year four. However, as with the adjustment to the base opex, we would also subtract the one-off factor adjustment from the year five incremental gain, which is now an incremental loss of 10 dollars. When the incremental gains/losses are carried forward the NSPs receives a single 10 dollar EBSS penalty in the final year of the next regulatory control period. Thus total opex revenue would be 500 dollars minus 10 dollars in EBSS carryovers. Total revenue is 490 dollars in both scenarios.

Extrinsic materials and Tribunal decisions

30 Significantly, relevant extrinsic materials and decisions made by the Australian Competition Tribunal disclose that the Chapter 6 economic regulatory regime is an incentives-based, ex ante regime.[17] This is in contrast to a 'cost-of-service' regime, under which DNSPs would be able to recover their actual costs of providing direct control services. The AEMC has observed that:[18]

> While cost-of-service regulation is based on remunerating TNSPs in respect of their actual costs, incentive regulation is based on remunerating TNSPs in respect of their forecast costs over the regulatory control period (which is typically three to five years). Because TNSPs are able to capture a proportion of the benefits of any unanticipated cost reductions (and must absorb unanticipated cost increases) that occur during a regulatory control period, they are encouraged to make cost savings. At the end of the period, the actual costs in this period may be used as a basis for establishing the reasonableness of the cost estimates provided by the TNSP in the subsequent regulatory period. In this way consumers share the benefits of the efficiency gains secured by the TNSP, just as in a competitive market costs savings are ultimately passed to customers as lower prices.

31 A consequence of this incentives-based, ex ante regime is that costs are typically not revisited and adjusted after the fact, regardless of what happens during the relevant RCP – this is a fundamental characteristic of the Chapter 6 regime. If circumstances change, such that the forecasts made at the beginning of the RCP are no longer accurate, no adjustment is made to reflect the change in

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17 AEMC, *2012 Final Determination – National Electricity Amendment (Economic Regulation of Network Service Provides) Rule 2012*, *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 29 November 2012, at p. 27.

18 AEMC, *2006 Final Determination – National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2005,* 16 November 2006, at p. 93 (in relation to transmission, but equally applicable to distribution).

circumstances; DNSPs bear the risk of forecasts being too low, and are entitled to the benefits of forecasts being too high. The Australian Competition Tribunal has found that:[19]

> It might be asked why the NEL principles require that the regulated NSP be provided with the opportunity to recover at least its efficient costs. Why 'at least'? The issue of opportunity is critical to the answer. The regulatory framework does not guarantee recovery of costs, efficient or otherwise. Many events and circumstances, all characterised by various uncertainties, intervene between the ex ante regulatory setting of prices and the ex post assessment of whether costs were recovered. But if, as it were, the dice are loaded against the NSP at the outset by the regulator not providing the opportunity for it to recover its efficient costs (eg, by making insufficient provision for its operating costs or its cost of capital), then the NSP will not have the incentives to achieve the efficiency objectives, the achievement of which is the purpose of the regulatory regime.
>
> Thus, given that the regulatory setting of prices is determined prior to ascertaining the actual operating environment that will prevail during the regulatory control period, the regulatory framework may be said to err on the side of allowing at least the recovery of efficient costs. This is in the context of no adjustment generally being made after the event for changed circumstances.

32 In other circumstances, rule makers have recognised that there are some instances in which an ex post adjustment of expenditure is desirable in order to ensure that NSPs have effective incentives. In 2012, the Australian Energy Market Commission (**AEMC**) introduced a rule change that, among other things, gave the AER a power to undertake efficiency reviews of past capex, including the ability to preclude inefficient expenditure from being included in a DNSP's regulatory asset base (**RAB**).[20] This rule change was made as an exception to the general principle under the NER, that the AER cannot scrutinise the efficiency of past expenditure for the purposes of recovering any inefficiencies from the DNSP.

33 In the AEMC's 2012 final determination, it identified issues with the capex incentives under the NER as in force at that time, such that DNSPs may be incentivised to spend more than their capex allowance, knowing that this overspend would be included in their RAB roll forward, and recovered in future RCPs. The AEMC noted that:[21]

> 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.

34 The AEMC 2012 final determination contains the following observation on the role of capex incentives (pre rule change), which applies equally to the role of opex incentives:

> 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. 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. Conversely, if it spends less than its allowance it retains the benefit for the rest of the period.

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19 *Application by EnergyAustralia and Others* [2009] ACompT8 at [77] – [78] (own emphasis added).

20 AEMC, *2012 Final Determination – National Electricity Amendment (Economic Regulation of Network Service Provides) Rule 2012*, *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 29 November 2012, at p. 134.

21 AEMC, *2012 Final Determination – National Electricity Amendment (Economic Regulation of Network Service Provides) Rule 2012*, *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 29 November 2012, at p. 28.

AER Draft Decisions

Victorian DNSPs' 2021 - 2026 distribution determinations

AER decisions on forecast insurance opex

35 In their regulatory proposals and/or revised regulatory proposals for the 2021 – 2026 RCP, each of the Victorian DNSPs proposed a step change for insurance premiums. These step changes were designed to reflect, in particular, forecast increases in bushfire insurance prices, and, thus, costs in that RCP due to global insurance market conditions.

36 The AER ultimately included a step change for insurance premiums for each of the Victorian DNSPs, as follows:

36.1 A $45.1 million ($2020/21) step change for AusNet;

36.2 A $28.2 million ($2020/21) step change for Jemena;

36.3 A $67.7 million ($2020/21) step change for Powercor; and

36.4 A $28.9 million ($2020/21) step change for United Energy.

37 However, the forecast increase in insurance premium costs in the 2021 – 2026 RCP did not eventuate to the extent contemplated in each of the Victorian DNSPs' distribution determinations, with the result that each of the Victorian DNSPs will ultimately significantly underspend on insurance opex in 2021 – 2026 relative to the forecast insurance opex included in their 2021 – 2026 required revenue approved by the AER.

AER decisions on application of the EBSS in the 2021 – 2026 RCP

38 In making its distribution determinations for the Victorian DNSPs for the 2021 – 2026 RCP, the AER decided to apply the Version 2 EBSS to each of the Victorian DNSPs during that RCP.

39 The AER determined that, consistent with the Version 2 EBSS:

39.1 the length of the carryover period for the 2021 – 2026 RCP will be the same as the length of the DNSP's following RCP, noting that that RCP was expected to be five years commencing on 1 July 2026; and

39.2 in determining carryover amounts for the 2026 – 2031 RCP arising from the application of the EBSS in the 2021 – 2026 RCP, the AER will:

(a) exclude opex incurred on Guaranteed Service Level payments and debt raising costs (and, for AusNet, innovation program costs), as these costs are not forecast on a single year revealed cost basis;

(b) adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the distribution determination for the RCP, such as approved pass through amounts or opex for contingent projects;

(c) adjust actual opex to remove demand management innovation allowance opex because it is not included in the opex forecast (but is often reported by DNSPs as part of their standard control services opex);

(d) adjust actual opex to add capitalised opex that has been excluded from the RAB;

(e) adjust forecast opex and actual opex for inflation;

(f) adjust actual opex to reverse any movements in provisions;

(g) adjust opex for any services that will not be classified as standard control services in the 2026 – 2031 RCP, to the extent these costs are not forecast using a single year revealed cost approach and that excluding these costs better achieves the requirements of clause 6.5.8 of the NER.

Victorian DNSPs' 2026 – 2031 regulatory proposals

40 The Victorian DNSPs (other than AusNet) did not propose a step change for insurance premiums in their regulatory proposals for the 2026 – 2031 RCP. The Victorian DNSPs followed the AER's established base-step-trend approach to forecasting their opex (described above at paragraph 21).

41 As the Victorian DNSPs (other than AusNet) did not propose a step change for insurance premiums, their forecast insurance costs for the 2026 – 2031 RCP, included in their proposed forecast total opex, are equal to their actual insurance-related opex in the base year (being the 2024/25 regulatory year), adjusted to provide an estimate of opex for the final year of the RCP, and then trended forward to the 2026 – 2031 RCP by applying the rate of change.

42 AusNet proposed a step change of $10.5 million ($2025/26) over the 2026 – 2031 RCP for insurance opex. As AusNet proposed a step change for insurance premiums, its forecast insurance costs for the 2026 – 2031 RCP included in its proposed forecast total opex are equal to its actual insurance-related opex in its base year (being the 2022/23 regulatory year), adjusted to provide an estimate of opex for the final year of the RCP, trended forward to the 2026 – 2031 RCP by applying the rate of change, and adding the requested step change amount.

43 Each of the Victorian DNSPs also proposed EBSS carryover amounts arising from the application of the Version 2 EBSS in the 2021 – 2026 RCP.

AER Draft Decisions for the Victorian DNSPs for the 2026 – 2031 RCP

44 In its draft decision, the AER proposed three adjustments relating to our insurance premiums, as follows:

44.1 a non-recurrent efficiency gain is included in base year opex, which increases our opex allowance in each year of the 2026 – 2031 RCP in an amount equal to our underspend on insurance premiums in the base year (i.e. actual insurance premiums less the premium allowance in the base year);

44.2 a negative step change adjustment, calculated as the difference between the premium allowance and actual premium in the final year, that decreases our opex allowance in each year of the 2026 – 2031 RCP; and

44.3 an adjustment to the calculation of the EBSS carryover amounts arising from the application of the EBSS during the 2021 – 2026 RCP, to reflect the non-recurrent efficiency gain adjustment made to base opex.

45 We understand that these adjustments are intended by the AER to:

45.1 ensure the AER's alternative estimate of total forecast opex satisfies the opex criteria set out in clause 6.5.6(c) of the NER, by setting a forecast opex allowance equal to that required by a prudent operator;

45.2 remove the expected over forecasting of insurance premiums in the final year, so ensuring this over forecasting does not impact forecast opex for the 2026 – 2031 RCP; and

45.3 return all the 2021 – 2026 insurance premium underspends to customers through EBSS decrements six years later, in a manner consistent with all insurance underspends in 2021 - 2026 being non-recurrent efficiency gains, while ensuring we retain our share of insurance premiums underspends in the form of the time value of holding the underspends for six years.

46 The AER also declined to approve AusNet's proposed insurance premium step change.[22]

47 In its Draft Decisions for each of the Victorian DNSPs, the AER noted that:[23]

> The negative step change, calculated as the difference between the final year [insurance] premium allowance and [the] actual [insurance] premium, removes the expected over forecasting of insurance premiums in 2025 – 26, thus ensuring this over forecasting isn't continued into the 2026 – 2031 period. It then sets the non-recurrent efficiency gain in the base year equal to the insurance underspend in the base year. Together, this results in:
>
> - Forecast opex equal to that required by a prudent operator.
> - [AusNet/Jemena/Powercor/United Energy] returning all the 2021 – 26 insurance premium underspends through EBSS decrements six years later (treating the underspends as non-recurrent efficiency gains).'

HoustonKemp report

48 Brendan Quach, Senior Economist at HoustonKemp, was engaged to prepare an independent report that sets out his expert opinion on:[24]

48.1 the approach the AER is purporting to have taken to determining the Victorian DNSPs' insurance opex in the Draft Decisions, including:

(a) the AER's reasoning and rationale for its purported approach; and

(b) the AER's stated objectives for its purported approach;

48.2 the approach the AER has actually taken to determining the Victorian DNSPs' insurance opex in the Draft Decisions, including:

(a) whether the AER's actual approach is consistent with its purported approach as identified by HoustonKemp in response to the question at 48.1 above; and

(b) to the extent the AER's actual approach is inconsistent with its purported approach, whether the AER's approach nonetheless is consistent with the AER's rationale, and achieves the AER's objectives, identified by HoustonKemp in response to the question at 48.1(a) and 48.1(b) above;

48.3 the merits of the AER's reasoning, rationale and objectives as stated in the Draft Decisions and identified by HoustonKemp in response to the question set out at 48.1 above.

49 HoustonKemp found that:

49.1 The outcome of the AER's approach in its Draft Decisions, in terms of revenue impact, is not consistent with its stated intention. In particular, HoustonKemp found that each of the Victorian DNSPs will be worse off under the AER's approach (in NPV terms), than they would be if the insurance underspends of the 2021 – 2026 RCP were treated as non-recurrent efficiency gains in accordance with the EBSS applicable to the Victorian DNSPs in that period.[25] That is to say, putting aside any issues with the legality or merits of the

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22 AER, *Attachment 3 – Operating Expenditure – Draft Decision – AusNet distribution determination 2026 – 2031,* 30 September 2025, at p. 32.

23 AER, *Attachment 3 – Operating Expenditure – Draft Decision – AusNet distribution determination 2026 – 2031,* 30 September 2025, at p. 3. This statement may vary slightly across the Draft Decisions for each of the Victorian DNSPs.

24 HoustonKemp, *Victorian DNSP insurance premiums,* 26 November 2025.

25 HoustonKemp, *Victorian DNSP insurance premiums,* 26 November 2025, section 5.

approach the AER has taken, there are inconsistencies between what it says it has done, and what it has actually done.

49.2 In some instances, the AER's approach effected an outcome that was not simply a 'claw back' of the over-forecasting of insurance opex in the 2021 – 2026 RCP, but an ex post punishment of their underspends of those forecasts. In other words, not only were the Victorian DNSPs not rewarded in the manner they should have been under the AER's approach (if properly applied), but they will receive a penalty.

49.3 The Victorian DNSPs' underspends were not due to a simple forecasting error, rather, the DNSPs contributed to the underspend by efficient management of their costs. The AER's approach fails to take into account any measures the DNSPs have taken to reduce their insurance premium costs.

49.4 The AER's Draft Decisions have a range of detrimental implications for the operation of the Chapter 6 regime, and the Victorian DNSPs' incentives to operate efficiently, including by undermining the intent and objectives of:

(a) the total opex regime, as:

(i) opex costs are interrelated, with the result that the DNSPs will be disincentivised from managing their risk and efficiency as a whole when they are penalised in respect of one opex category, without being rewarded in another. The AER's decision effectively establishes a subcomponent allowance for insurance costs, rather than treating opex as a whole;

(ii) the AER's adjustments do not recognise the DNSPs' costs spent on risk mitigation in other categories that may operate to reduce their insurance premiums, such as vegetation management opex. DNSPs will be disincentivised from managing their risk and efficiency as a whole.

(b) the NEL/NER economic regulatory regime, as the use of an ex post adjustment for ex ante 'forecasting error' is inconsistent with the principles of ex ante, incentives-based regulation; and

(c) the EBSS, as the actual treatment of non-recurrent efficiency gains and the negative step change results in an outcome that is not a fair sharing scheme. Additionally, the AER's adjustments are inconsistent with the intended purpose of the Version 2 EBSS and the non-recurrent efficiency gain mechanism.

Consideration

50 The Victorian DNSPs have asked for consideration to be given to the legality of the AER's approach to assessing their insurance opex. Having regard to the regulatory framework, AER documents and extrinsic material set out above, there are four legal issues with the AER's decision that arise for consideration:

50.1 whether the AER's Draft Decisions, which treat the Victorian DNSPs' underspends on insurance premiums in their respective base years as a non-recurrent efficiency gain, in combination with a negative step change, are authorised by any statutory provision;

50.2 whether the AER's Draft Decisions, which effect a clawback of the Victorian DNSPs' underspends on insurance premiums in the 2021 – 2026 RCP (and indeed, penalises the Victorian DNSPs for the underspends), are contrary to the scheme of Chapter 6 of the NER;

50.3 whether the AER's Draft Decisions contravene section 16(1) of the NEL, in particular, whether the AER is exercising its economic regulatory function or power in a manner that will or is likely to contribute to the achievement of the NEO; and

50.4 whether the reasoning of, and rationale for, the AER's Draft Decisions are unreasonable.

51 Each of these issues is discussed in further detail below.

Issue 1: Whether the AER's decision to treat insurance premium underspends as a non-recurrent efficiency gain is authorised by the EBSS and the NER

52 Clause 6.4.3(a) of the NER provides that the annual revenue requirement for each regulatory year of a regulatory control period must be determined using a building block approach. Under clause 6.4.3(a)(5), one of these building blocks includes the revenue increments or decrements for that year arising from the application of any EBSS (in addition to other specified schemes).

53 Clause 6.4.3(b)(5) provides that the revenue increments and decrements referred to in clause 6.4.3(a)(5) are those that arise as a result of the operation of an applicable EBSS as referred to in clause 6.5.8 (in addition to other specified schemes as referred to in other specified clauses). Clause 6.5.8 empowers the AER to develop and publish an EBSS that provides for a fair sharing between DNSPs and network users of efficiency gains (and losses) derived from opex for an RCP being less (or more) than the forecast opex accepted or substituted by the AER for that RCP.

54 As discussed above, a distribution determination is predicated on certain constituent decisions made by the AER, including a decision on how any applicable EBSS is to apply to the DNSP for the duration of the relevant RCP. As part of its final distribution determination decision for a DNSP, the AER will specify how any then applicable EBSS will apply to the DNSP in the forthcoming RCP.

55 The AER's decision on the application of the EBSS is binding; the NER does not permit the retrospective amendment of the operation of the EBSS at the end of an RCP. Once the AER has determined how the EBSS will apply to a DNSP for a given RCP, it must adhere to that decision, including in particular the provisions of that EBSS applied by that decision, when calculating carryover amounts resulting from the application of the EBSS to opex incurred during that same RCP.

56 That the AER's EBSS decision is binding is widely accepted, including by the AER. If the AER wants to exclude certain costs from its application of the EBSS in a RCP, it must provide for this in its ex-ante decision on how the EBSS is to apply in that RCP, either by amending the EBSS to expressly provide for these exclusions before the amended EBSS is applied or in its decision specifying how the EBSS is to apply in the RCP. This is one of the reasons why the AER amended the EBSS in 2013 (resulting in the Version 2 EBSS); it wished to allow for the ex post exclusion of categories of opex not forecast using a single year revealed cost approach in the following period in calculating the EBSS carryover amounts for that period.

57 Although the AER introduced the Version 2 EBSS in 2013, it was not permitted to apply that version when calculating carryover amounts for opex incurred during the 2011–2015 RCP. The AER was bound to use the EBSS originally published by the AER for DNSPs in June 2008 (**Version 1 EBSS**), as it had determined at the outset of that RCP that the Version 1 EBSS would apply to the Victorian DNSPs for that RCP. This is evident from the AER's final determination for Powercor for the 2016 – 2020 RCP, in which it noted:[26]

> During the 2011 – 15 regulatory control period, Powercor operated under the Electricity distribution network service providers' EBSS released in June 2008.

58 The AER calculated Powercor's carryover amounts for the 2016 – 2020 RCP in accordance with the Version 1 EBSS, before deciding that the Version 2 EBSS would apply to Powercor for the 2016 – 2020 RCP.

59 When making each of the Victorian DNSPs' distribution determinations for the 2021 – 2026 RCP, the AER's final decision was that the Version 2 EBSS should apply. Accordingly, the AER is bound to apply the Version 2 EBSS when calculating EBSS carryover amounts resulting from opex incurred during the 2021 – 2026 RCP.

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26 AER, *Attachment 9 – Efficiency benefit sharing scheme, Powercor distribution determination final decision 2016 – 2020,* 26 May 2016, at p. 6.

60 The AER's Draft Decisions treat the Victorian DNSPs' insurance premium underspends in their respective base years as a 'non-recurrent efficiency gain', used in combination with a negative step change, to 'clawback' the Victorian DNSPs' underspends on insurance premiums in the 2021 – 2026 RCP. The Version 2 EBSS does not define the term 'non-recurrent efficiency gain', nor does it provide any meaningful commentary on what that term means, and how it should be applied.

61 However, further detail is found in the AER's accompanying Explanatory Statement, where non-recurrent efficiency gains are discussed under the heading 'one-off factors in the base year'. In particular, the Explanatory Statement provides that:[27]

61.1 expenditure should be treated as a non-recurrent efficiency gain in circumstances where a DNSP cannot sustain the level of expenditure that it incurred in the base year, as a result of a one-off factor that led to an underspend relative to forecast opex in that base year; and

61.2 the purpose of the non-recurrent efficiency gain adjustment is to enable revenue to be shifted from the EBSS carryover to the opex allowance, rather than to effect a reduction in overall allowed revenue.

62 It is clear from the Explanatory Statement that the AER is permitted by the Version 2 EBSS, and thus the NER, to treat an opex underspend in the base year as a non-recurrent efficiency gain in limited circumstances, and that DNSPs should not be left worse off in their total revenue allowance as a result of any base year non-recurrent efficiency gain. The EBSS does not provide for the non-recurrent efficiency gain concept to be used as a mechanism to recover opex underspends from DNSPs.

63 Further, no provision was made, by the AER's decision on how the Version 2 EBSS was to apply to the Victorian DNSPs in the 2021 – 2026 RCP, for any supplementary or expanded use of this non-recurrent efficiency gain concept.

64 The AER's three step approach to assessing insurance premiums is not authorised by the Version 2 EBSS or the NER. This is because:

64.1 the insurance premium underspend in the base year cannot properly be characterised as a non-recurrent efficiency gain in that base year. The underspend did not occur only in the base year, as a result of a one-off factor. Each Victorian DNSP underspent in multiple years of the RCP, and I am instructed that they are able to sustain this reduced level of expenditure going forward;[28]

64.2 further, by treating the insurance premiums underspend in the base year as a non-recurrent efficiency gain, in combination with a negative step change, the AER is not merely shifting revenue from the EBSS carryover to the opex allowance. Rather, the AER is reducing the Victorian DNSPs' overall revenue allowance. This was demonstrated in HoustonKemp's report, as discussed above at 49.1.[29] The non-recurrent efficiency gain, considered in isolation, does not change the overall revenue allowance materially, as it increases the opex allowance by an amount sufficient to compensate the DNSP for the resultant negative carryover amounts. However, the negative step change is used, together with the non-recurrent efficiency gain, to reverse the effect of the non-recurrent efficiency gain on the opex allowance. The negative step change is, in effect, doing two things – it is removing the positive effect on the opex allowance that the non-recurrent efficiency gain would have (which would offset the negative effect of that gain on the carryover amounts), as well as removing the impact of the over forecast for the final year of 2021-26 from the 2026 - 31 forecasts. The addition of the non-recurrent efficiency gain to base year actual opex is not required to deliver sufficient opex for 2026-31. It is apparent that the AER uses the device of

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27 AER, *Better Regulation, Explanatory Statement, Efficiency Benefit Sharing Scheme,* November 2013, at p. 20.

28 Marsh, *Victoria Power Networks Pty Ltd and United Energy Distribution Pty Ltd – Insurance Premium Forecast Report for 2026 – 2031 Regulatory Control Period*, 26 November 2025; Lockton, *Jemena Electricity Networks (Vic) Ltd Insurance Premium Forecast*, November 2025; Lockton, *AusNet Electricity Services Ltd – Addendum*, 26 November 2025.

29 HoustonKemp, *Victorian DNSP insurance premiums,* 16 November 2025, section 5.

employing the non-recurrent efficiency gain in combination with the negative step change, so as to clawback the insurance underspend, by reducing the overall revenue received by the DNSPs, while still ensuring that the opex allowance reflects the insurance costs of a prudent and efficient operator. The non-recurrent efficiency gain plays an essential role in the mechanism used by the AER to achieve these goals.

65 On this basis, the AER's Draft Decision makes an adjustment to the calculation of the EBSS negative carryover amounts for the 2026 – 2031 RCP that the AER does not have the power to make. The AER is bound to apply the Version 2 EBSS, when calculating the Victorian DNSPs' EBSS carryover amounts for that RCP. The AER has not followed the Version 2 EBSS, as applied by its distribution determinations for the 2021 – 2026 RCP, when calculating the Victorian DNSPs' carryover amounts, as it purports to make adjustments which are outside the scope of the Version 2 EBSS, and are not provided for in those distribution determination in applying that EBSS in the 2021 – 2026 RCP.

Issue 2: Whether the AER's decision is contrary to the scheme of the NEL and NER

66 The Chapter 6 economic regulatory regime is an incentives-based, ex ante regime. This is clear from extrinsic material and the previous Australian Competition Tribunal decisions, including those set out above, and the provisions of Chapter 6 itself. Under this regime, DNSPs are not guaranteed to recover their actual costs of providing direct control services, rather, they are remunerated in respect of their forecast costs. As DNSPs are able to keep a proportion of the benefits of any unanticipated cost reductions (relative to forecast) that occur during an RCP, they are incentivised to make cost savings and incur only their efficient costs. The converse of this is that DNSPs must also absorb a proportion of unanticipated cost increases.

67 Clause 6.5.6 of the NER, read alongside clause 6.4.3, gives effect to the principles set out above in respect of opex. Clause 6.5.6 requires a DNSP's building block proposal to include a forecast of the opex it considers is required to meet or manage expected demand, comply with all applicable regulatory obligations, and to maintain the safety, reliability, quality and security of a DNSP's network, in relation to the distribution service that a DNSP provides. Clause 6.4.3 provides that the forecast opex for each year is one of the building blocks that comprises a DNSP's annual revenue requirement.

68 Neither clause 6.5.6 nor clause 6.4.3 provide for the AER to revisit opex incurred in a previous RCP, other than for the purposes of calculating any revenue increments or decrements arising from the application of a relevant scheme (including the EBSS) or a control mechanism.

69 The Australian Competition Tribunal has recognised that this is the way in which the regulatory regime operates (in *Application by EnergyAustralia and Others* [2009] ACompT8). In particular, the Tribunal observed that, generally, no adjustment is made to revenue after the event to reflect changed circumstances.[30]

70 Consistent with the Tribunal's observation, it is noted that, generally, there is no mechanism under the NER for the AER to conduct an ex post review of a DNSPs expenditure, for the purposes of clawing back any efficiencies (or inefficiencies), or making adjustments to reflect changed circumstances that render expenditure forecasts inaccurate. There are limited exceptions to this general rule. For example, clause S6.2.2A permits the AER to scrutinise the efficiency of a DNSP's past capex, and make an adjustment to the RAB where past capex is found to be inefficient. This exception was introduced to remedy issues that are specific to capex incentives under the NER, where a DNSP was able to recover capex overspend through the NER's RAB roll-forward mechanism, in circumstances where this overspend may have been inefficient.[31]

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30 *Application by EnergyAustralia and Others* [2009] ACompT8 at [77] – [78] (own emphasis added).

31 AEMC, *2012 Final Determination – National Electricity Amendment (Economic Regulation of Network Service Provides) Rule 2012*, *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 29 November 2012, at p. 6.

71 The AEMC has not introduced an equivalent mechanism for opex; the AER is not able to scrutinise a DNSP's past opex for the purposes of making adjustments to that DNSP's allowable revenue in a forthcoming RCP.

72 The AER's Draft Decisions:

72.1 effectively claw back the Victorian DNSPs' underspends on insurance premiums in the 2021 – 2026 RCP, relative to the forecast determined at the outset of that RCP; and

72.2 as a result, are inconsistent with the scheme of the NER, being that of incentive based, ex ante regulation, as they seek to ensure that the Victorian DNSPs are only able to recover their actual costs for insurance premiums.

73 That the AER's Draft Decisions are inconsistent with the scheme of the NER can be further demonstrated by having regard to the likely effects of the Decisions, as observed by HoustonKemp. Certainty is key to incentive based regulation. DNSPs must have certainty that they will be permitted to keep a proportion of the benefit of any underspend of the overall opex allowance, in order for there to be an incentive to make cost savings. If the DNSPs do not have this certainty, because the AER has demonstrated that it will apply an inconsistent approach and clawback some underspends at its discretion, the incentives to make cost savings fall away.

74 This uncertainty is heightened by the fact that the AER has not applied a consistent approach to assessing opex overspends and underspends. Rather, the AER has focused solely on insurance premium underspends, in circumstances where DNSPs have materially overspent in other categories. This means that DNSPs are likely to consider that they will be, at best, not rewarded, and at worst, penalised, for any opex underspend, without any equivalent treatment for opex overspends.

75 For the reasons discussed above, the AER's Draft Decisions are inconsistent with the scheme of Chapter 6 of the NER; the AER is not permitted to claw back DNSP underspends, except in limited, express circumstances (which do not apply here).

Issue 3: Whether the AER's decision contravenes section 16(1) of the NEL

76 Section 16(1) of the NEL requires the AER to, in performing or exercising an AER economic regulatory function or power, perform or exercise that function or power in a manner that will or is likely to contribute to the achievement of the NEO. As established above, the AER's making of a distribution determination is an 'AER economic regulatory function or power'.

77 Section 7A of the NEL sets out the revenue and pricing principles. The Australian Competition Tribunal has recognised that a decision which is inconsistent with the revenue and pricing principles cannot be a decision that will or is likely to contribute to the achievement of the NEO.[32]

78 Relevantly, the revenue and pricing principles provide that: [33]

78.1 a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services, and complying with a regulatory obligation or requirement or making a regulatory payment; and

78.2 a regulated network service provider should be provided with effective incentives, in order to promote economic efficiency with respect to the direct control services the operator provides. Economic efficiency includes efficient investment in the system with which it provides services, efficient provision of services, and efficient use of the system.

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32 *Re Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3 at [15].

33 *National Electricity Law*, section 7A(2) and (3).

79 The Australian Competition Tribunal has recognised the importance of regulated NSPs being provided with the opportunity to recover at least their efficient costs, in the *EnergyAustralia* decision referred to above. In particular, the Australian Competition Tribunal noted:

> It might be asked why the NEL principles require that the regulated NSP be provided with the opportunity to recover at least its efficient costs. Why 'at least'? The issue of opportunity is critical to the answer. The regulatory framework does not guarantee recovery of costs, efficient or otherwise. Many events and circumstances, all characterised by various uncertainties, intervene between the ex ante regulatory setting of prices and the ex post assessment of whether costs were recovered. But if, as it were, the dice are loaded against the NSP at the outset by the regulator not providing the opportunity for it to recover its efficient costs (eg, by making insufficient provision for its operating costs or its cost of capital), then the NSP will not have the incentives to achieve the efficiency objectives, the achievement of which is the purpose of the regulatory regime.
>
> Thus, given that the regulatory setting of prices is determined prior to ascertaining the actual operating environment that will prevail during the regulatory control period, the regulatory framework may be said to err on the side of allowing at least the recovery of efficient costs.

80 The AER's Draft Decisions do not provide the Victorian DNSPs with a reasonable opportunity to recover at least the efficient costs they incur in providing direct control network services, as identified in section 5.3 of the HoustonKemp report. In particular, HoustonKemp concludes:

80.1 the Draft Decisions, which claw back gains from insurance cost increases being less than forecast, introduce an asymmetric risk that means the Victorian DNSPs do not have a reasonable opportunity to recover their efficient costs;

80.2 this asymmetry arises because the AER has only reclassified, on an ex post basis, insurance cost outperformance as temporary, without articulating a general principle as to when a material forecasting error will be reclassified as temporary. Specifically, the Draft Decisions do not consider whether the AER should reclassify cost increases that were materially higher than forecast as temporary efficiency losses;

80.3 instead, forecasts that materially underestimate the actual opex costs of the DNSP are treated as perpetual cost increases and subject to higher EBSS penalties. There are a number of examples over the 2021-26 regulatory control period where actual costs were materially higher than forecast over that period. These forecasting errors have not been examined by the AER to assess whether they should be reclassified as temporary in nature;

80.4 a regulatory framework that provides for the retrospective lowering of the rewards for outperformance but does not provide for retrospectively lowering the penalties for underperformance introduces a downward bias in outcomes and, consequently, does not provide DNSPs with a reasonable opportunity to recover their efficient costs.

81 In addition, the AER's Draft Decisions, if finalised, will have the effect of distorting the Victorian DNSPs' incentives to provide their direct control services in a manner that promotes economic efficiency. The effect of the AER's Draft Decisions on DNSP incentives is discussed in further detail in the HoustonKemp report. In particular, HoustonKemp notes that the AER's approach undermines the objective and intent of the incentives-based regulatory regime, including because:

81.1 the use of ex post adjustments for ex ante 'errors' undermines the incentives regime. DNSPs will no longer have certainty that they will be rewarded for outperforming their opex allowance;

81.2 the AER has reclassified, on an ex post basis, insurance cost outperformance as temporary, without articulating a general principle as to when a material difference in actual costs relative to forecasts will be reclassified as temporary. In particular, the AER does not specify whether it will reclassify expenditure that was materially higher than forecast as a temporary efficiency loss. This lack of certainty, and asymmetry, reduces DNSPs' incentives to operate efficiently;

81.3 the Draft Decisions undermine the total opex regime. The AER's Draft Decisions effectively establish a subcomponent allowance for insurance costs, which ignores the uncertainty of forecasting individual cost components and that DNSPs will outperform on some cost components but underperform on others, but must manage their overall opex within their budget. This diminishes DNSPs' incentives to efficiently reduce costs. DNSPs will be hesitant to reduce bushfire insurance costs by investing in mitigation measures, even when it is efficient to do so. DNSPs will fear that the expected benefits of reducing their insurance costs may be lost, but that they will bear the full cost of the other mitigation measures; and

81.4 the Draft Decisions do not provide for a fair sharing of temporary efficiency gains. In other words, putting aside the legality or merits of the AER's decision, the revenue outcome under the AER's approach does not appear to be consistent with its stated intention.

82 It is clear, from the HoustonKemp report, that the AER's Draft Decisions are inconsistent with the revenue and pricing principles, as they do not provide the Victorian DNSPs with a reasonable opportunity to recover at least the efficient costs they incur in providing direct control services, or an effective incentive to promote economic efficiency when providing direct control services. Accordingly, consistent with the Australian Competition Tribunal's previous decisions, the AER's decision on insurance opex in each of its Draft Decisions cannot be a decision that will or is likely to contribute to the achievement of the NEO. As a result, the AER's Draft Decisions contravene section 16(1) of the NEL.

Issue 4: Whether the reasoning of, and rationale for, the AER's Draft Decisions are unreasonable

83 For the reasons set out in the independent report of HoustonKemp, the reasoning and rationale for the AER's Draft Decisions are unreasonable and not rational.

The Hon. John Middleton, AM KC

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