Rule change proposal

Economic regulation of transmission and distribution network service providers

AER's proposed changes to the National Electricity Rules

September 2011

AUSTRALIAN ENERGY REGULATOR

For the purposes of section 92 of the *National Electricity Law*, this rule change is proposed by:

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The following matters are set out in Parts A, B and C of this rule change proposal:

- a description of the Rules that the AER proposes be made
- a statement of the nature and scope of the issue that is proposed to be addressed and an explanation of how the proposed Rule would address the issue
- an explanation of how the proposed Rules will or are likely to contribute to the achievement of the national electricity objective
- an explanation of the expected benefits and costs and the potential impacts of the proposed Rules on those likely to be affected.

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PART A – OVERVIEW AND CONTEXT

1 Introduction

Among its roles, the Australian Energy Regulator (AER) is responsible for the economic regulation of electricity transmission and distribution network service providers (NSPs) in the national electricity market (NEM). This regulatory role is performed under chapters 6 and 6A of the National Electricity Rules (NER) for distribution and transmission respectively.

Since the commencement of the current chapters 6 and 6A the AER has completed four transmission determinations and 12 distribution determinations. An entire round of network determinations for all NSPs in the NEM will be completed following the release of the Powerlink transmission and Aurora distribution determinations in April 2012.

The AER has undertaken an internal review of the operation of the current chapters 6 and 6A of the NER. This review has found that in some areas the regulatory framework is operating well. Further, the AER is continuing to develop its own processes to improve the effectiveness of economic regulation. However, this review has also identified deficiencies in the existing regulatory framework that applies to NSPs. This rule change proposal is designed to address these deficiencies. At a high level, the amendments involve three classes of proposed changes to the NER. These relate to:

- the capital and operating expenditure (capex and opex) framework, including removing some of the restrictions on the AER's ability to assess and respond to proposals
- incentive arrangements, including changes to provide stronger incentives for NSPs to spend no more than is necessary and efficient, while providing a robust framework to deal with uncertainty
- the cost of capital, including establishing a new streamlined framework for setting the cost of capital parameters and providing greater certainty.

The rule change proposal also includes amendments to improve the efficiency of the regulatory determination process and promote effective stakeholder engagement in the process for making regulatory determinations. In addition, rule changes are proposed to enable consumers to share the benefits of unregulated income earned from (shared) regulated assets.

These amendments will make an important contribution to furthering the National Electricity Objective (NEO), which is to:

> promote efficient investment in, and operation and use of, electricity services for the long term interests of consumers 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.

This rule change proposal is structured in three parts.

Part A outlines the main issues that the rule change proposal is seeking to address and outlines the proposed amendments to the NER at a high level. The rest of Part A is structured as follows:

- Section 2 provides background to this rule change proposal. It discusses the features of the current regulatory framework, the experience with the first round of regulatory resets and the current policy debate

- Section 3 provides a statement of issues concerning the existing provisions in the NER

- Section 4 provides an outline of the proposed changes to the NER

- Section 5 outlines how the proposed changes to the NER will contribute to the achievement of the NEO and discusses impacts on those likely to be affected by the rule change proposal.

Part B provides more detailed analysis on each proposed amendment to the NER. For each proposed rule change, Part B discusses the operation of the current rule, the proposed rule change, how the proposed rule addresses the identified issues, how the rule change proposal contributes to the achievement of the NEO and the revenue and pricing principles, and the potential impacts on those affected by the rule change proposal. Part C sets out draft rules prepared by the AER.

Also provided with this proposal is independent legal advice from Stephen Lloyd SC on whether the:

- existing rules have a susceptibility to systemic bias in making distribution determinations and transmission determinations

- AER's proposed rules would reduce or remove any existing systemic bias

- proposed rules allow the AER to make determinations and that are consistent with the NEO and the revenue and pricing principles set out in the NEL.

Lloyd SC considers that there are key aspects of the current rules that are susceptible to inefficient investment or a bias in favour of NSPs. Lloyd SC considers that if made, the AER's proposed rules would reduce or remove this bias and contribute to the achievement of the NEO.

Also attached to this proposal is advice from the Australian Government Solicitor (AGS) commissioned by the AER. This advice recommends rule drafting to address a problem with the current process rules discussed further in Chapter 8 of Part B.

2 Background

2.1 Development of the current regulatory framework

Before the establishment of the AER in 2005, the Australian Competition and Consumer Commission (ACCC) was responsible for the economic regulation of transmission network service providers (TNSPs) in the NEM. The National Electricity Code (the code) set out principles to guide the ACCC in this role, with more detailed regulatory methodology specified in supporting guidelines published by the ACCC. The key guideline published by the ACCC to support its role was the statement of regulatory principles (SRP). The SRP did not form part of the code and the ACCC's application of the SRP to a particular TNSP depended on individual circumstances. The ACCC was able to depart from the SRP where required or justified by the code provisions.

In 2005, the AER assumed the ACCC's responsibilities for the economic regulation of TNSPs and the NER replaced the code. Pursuant to the *National Electricity Law* (NEL), the Australian Energy Market Commission (AEMC) was required to review the rules governing the regulation of electricity transmission revenues.[1] This process culminated with the release in November 2006 of new rules governing the regulation of transmission revenues in the NEM.[2] These rules were specified in a new chapter 6A of the NER and replaced the previous provisions that the ACCC applied under the code. This was then followed by the development of new rules for the economic regulation of distribution services.[3] These rules, developed by the Ministerial Council on Energy (MCE), were specified in a new chapter 6 of the NER.[4] Although there are some significant differences, chapter 6 was largely based on chapter 6A.

At the time chapter 6A was being developed, the AER argued that the existing regulatory framework was supporting significant increases in transmission network investment. Nonetheless, there was a perception that the economic regulatory process was an impediment to further investment in essential infrastructure.[5] In developing chapter 6A, the AEMC was concerned to minimise the potential for this regulatory risk. The AEMC stated:[6]

> The potential for failures in the regulatory process can impose costs and inefficiencies; including the direct costs incurred by regulated businesses and the regulator and the costs to society as a whole through the potential for regulatory error and induced inefficiencies.

The AEMC's approach to addressing these perceived risks was to prescribe key elements of the rules governing the regulation of TNSPs in the NER, including codifying aspects of the SRP (but with a number of key changes). Chapter 6A, and chapter 6 which followed, codified not only the procedural rules that govern the process by which regulatory decisions are made, such as decision making timeframes,

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1 *National Electricity Law* (NEL), s 35 (as set out in the Schedule to the *National Electricity (South Australia) Act 1996* (SA) at 1 July 2005.

2 National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18.

3 National Electricity (Economic Regulation of Distribution Services) Amendment Rules 2007.

4 These Rules were made under section 90A of the National Electricity Law).

5 This argument was most strongly promoted by the Productivity Commission. See Productivity Commission (2001), *Review of the National Access Regime*, Report no. 17, 2001, AusInfo, Canberra; Productivity Commission (2004), *Review of the Gas Access Regime*, Report no. 31, Ausinfo, Canberra; Exports and Infrastructure Taskforce (2005), *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005.

6 AEMC, *Rule Determination: National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18*, 16 November 2006, p. xiii (*Rule Determination*).

but also core elements of the substantive rules. This included specifying in the NER the methodologies and decision making criteria that govern the application of regulation to individual businesses. This was a significantly different approach to other state based regulatory regimes or those in existence in other countries.

In developing this prescriptive regulatory framework, the AEMC sought to 'improve the environment for investment by increasing regulatory clarity and certainty through the Rules.'[7] In developing chapter 6A, the AEMC was mindful of the need to balance the interests of NSPs and users, but was not in a position to gauge the potential impact on regulatory forecasts and increases in prices that could result from the framework as developed.

At the time, the AER expressed concern with the framework that was being developed. The AER argued that the framework would not deliver effective incentives for efficient investment, would tilt the regulatory balance in favour of the NSPs and would limit the AER's capacity to respond to the individual circumstances of each NSP.[8]

The AER has applied the framework that was developed to four transmission determinations and twelve distribution determinations. These experiences have reinforced the AER's view that the regulatory regime inappropriately favours NSPs and consumers are paying more than they should to maintain a reliable and secure power system.

2.2 Recent electricity price rises

Most states and territories in Australia experienced relatively low and stable electricity prices between the commencement of the NEM in 1998 and 2007. While real electricity prices have trended upwards since 2001, there have been more rapid price increases since 2007 in most states and territories (Figure 1.1). Between 2007 and 2011 Australian household electricity prices have increased 35 per cent in real terms.[9] In its most recent report on electricity price rises in NSW, the Independent Pricing and Regulatory Tribunal (IPART) noted that on 1 July 2010 annual electricity bills for an indicative residential customer would increase between $216 and $316 per year.[10]

The AEMC has noted that household electricity prices are likely to continue to rise. It has forecast that electricity prices will rise by 19 per cent in real terms between 2009–10 and 2012–13.[11]

There has been increasing community concern regarding these recent increases in electricity prices. In his Climate Change Review Update, Professor Ross Garnaut

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7 ibid., p. xiii.

8 See for example AER, *Submission to Australian Energy Market Commission, Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006*, March 2006.

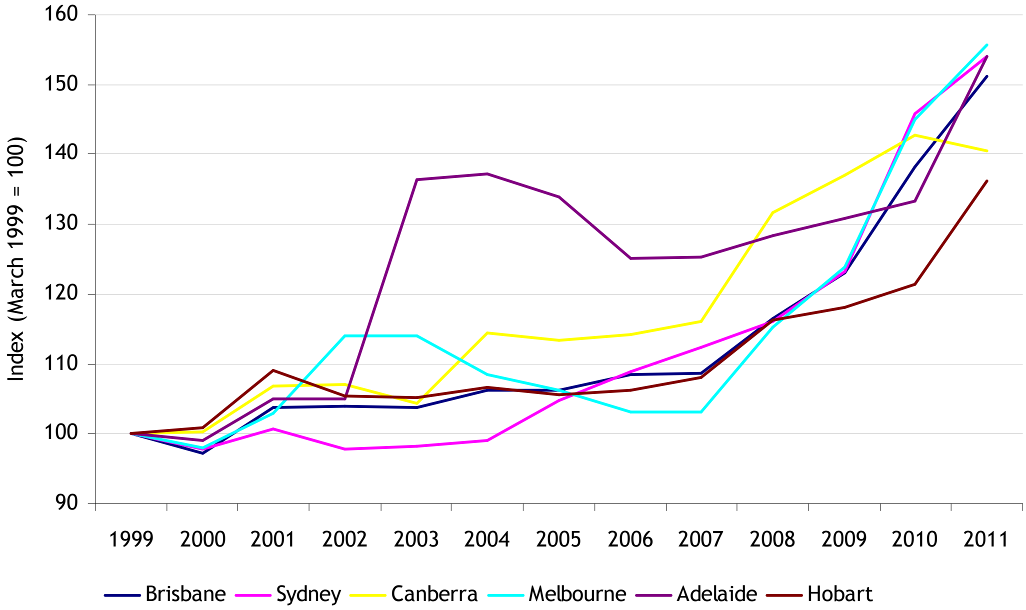
9 ABS, *Consumer Price Index*, cat.no. 6401.0.

10 Estimates for an indicative residential customer on the regulated tariff (with an annual consumption of 7000 kWh). IPART, *Changes in regulated retail prices from 1 July 2011—Final report*, June 2011, p. 4.

11 AEMC, *Future possible retail electricity price movements: 1 July 2010 to 30 June 2013*, 30 November 2010, p. i.

noted that the recent rises in electricity prices have been well ahead of the general increase in prices and faster than the growth in average wages. Professor Garnaut considered that these price rises are putting pressure on low income households.[12]

Figure 1.1 Electricity retail price index (inflation adjusted), Australian capital cities



Note: Consumer price index electricity series, deflated by the consumer price index for all groups

Source: ABS, *Consumer price index*, cat. no. 6401.0, various years.

Similarly, the December 2010 *NSW Electricity Network and Prices Inquiry* Report noted that since 2008 electricity prices in NSW have been growing at a faster rate then average weekly earnings. This suggests that a greater proportion of household expenditure is now being spent on electricity bills.[13] IPART has also expressed concern about electricity affordability for low-income, high consumption households following recent increases.[14]

Drivers for higher prices

There are a number of reasons for recent electricity price increases. One factor driving up electricity prices in 2007 and 2008 related to higher wholesale energy prices.[15] However a significant proportion of the more recent rises can be attributed to increases in regulated network charges.[16]

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12 Professor Ross Garnaut, *Garnaut climate change review—Update 2011 'Transforming the electricity sector—Update paper 8'*, 2011, p. 6.

13 New South Wales Government, *NSW Electricity network and prices inquiry—Final report*, December 2010 (the Duffy-Parry report), p. 9.

14 IPART, *Changes in regulated retail prices from 1 July 2011—Final report*, June 2011, p. 72.

15 AER, *State of the Energy Market*, 2010, p. 103.

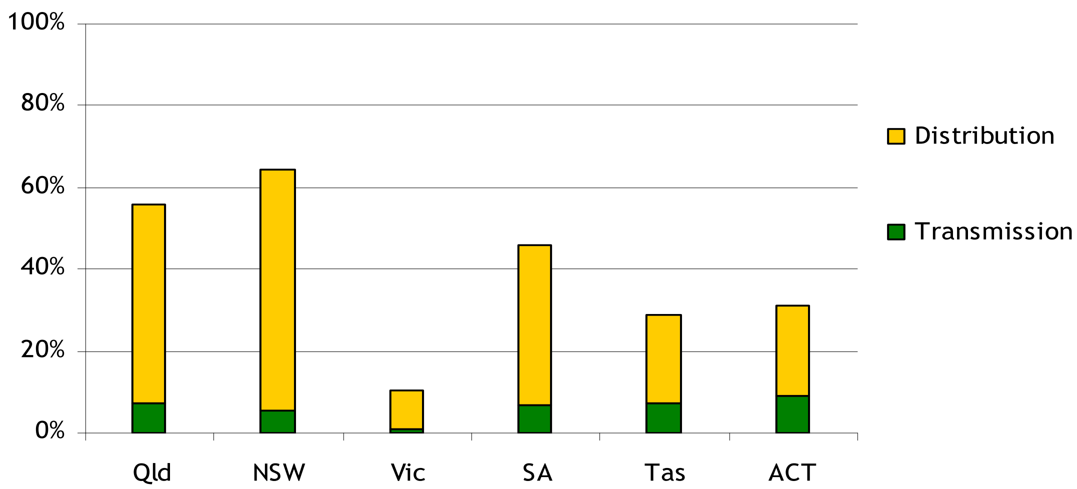
16 For further discussion of recent electricity price rises: see ibid., pp. 100–103.

Network charges account for up to 50 per cent of a typical customer's electricity bill and rises in these charges have a significant impact on the overall electricity price. For example for regulated electricity prices in NSW, network charges have accounted for around 50 per cent of 2009–10 increases, 80 per cent of the 2010–11 increases and 53 per cent of the 2011–12 increases.[17]

The increasing cost of electricity network services is expected to continue to affect overall electricity prices. The AEMC has noted that the increasing cost of distribution services alone are expected to contribute around 41 per cent of the total increase in electricity prices (at a national level) between 2009–10 and 2012–13.[18] Transmission costs will contribute a further 8 per cent of the expected total increase.[19] With the exception of Victoria, network charges will account for a significant proportion of expected price increases, with the effects particularly pronounced in NSW and Queensland (Figure 1.2).

Recent increases in network charges have been driven in part by the need for increased investment to replace ageing assets and to meet increased peak demand, growing customer connections and higher reliability standards. Higher forecasts to cover expected increases in labour and materials costs have also contributed to increases in network prices. However, these drivers do not fully account for the level of observed increases.

Figure 1.2 The contribution of network charges to future possible residential electricity price increases (2009–10 to 2012–13)



Source: AEMC, *Future possible retail electricity price movements: 1 July 2010 to 30 June 2013*, 30 November 2010

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[17] IPART, *Market-based electricity purchase cost allowance—2009 electricity review, final report and determination*, 2009; IPART, *Regulated electricity retail tariffs for 1 July 2010 to 30 June 2013—final report*, Fact sheet, 2010.

[18] AEMC, *Future possible retail electricity price movements: 1 July 2010 to 30 June 2013,* 30 November 2010, p. i.

[19] ibid., p. iv.

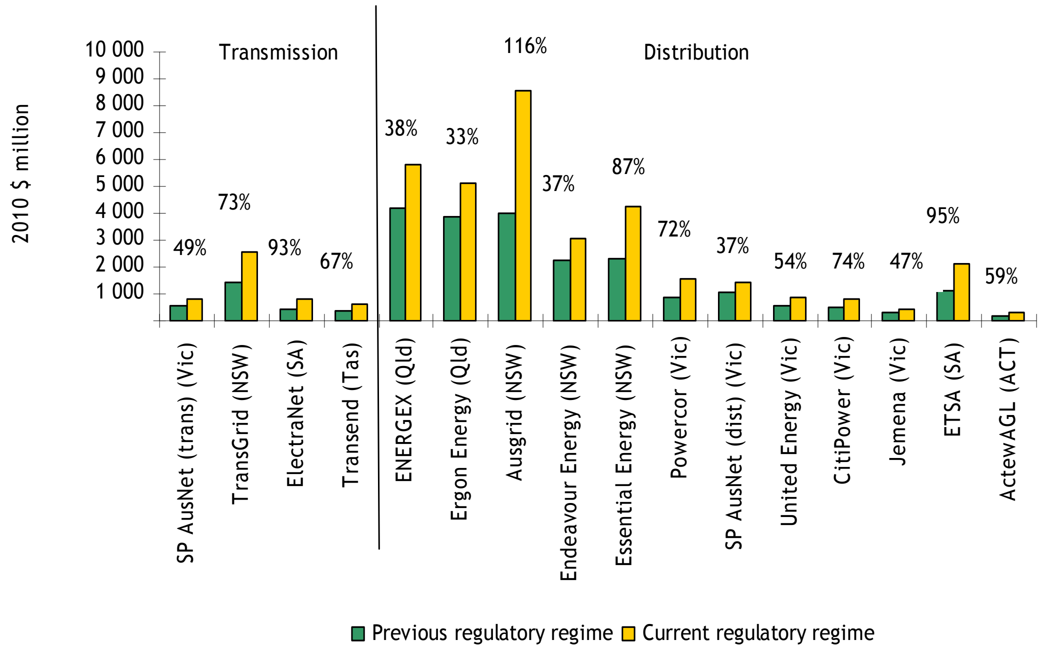
2.3 Outcomes from first round of network determinations

The AER has made final determinations for most NSPs subject to the current chapters 6 and 6A of the NER. Following the implementation of the current framework, there have been significant increases in capital and operating expenditure (capex and opex) forecasts in final determinations. In aggregate, the AER's final determinations have forecast over $55 billion (in real terms) in capex and opex for the current periods.

On average across all networks, proposed forecasts of capex from NSPs were 84 per cent higher (in real terms) than actual expenditure in the previous regulatory period. While the AER reduced these forecasts in its final determinations, the approved forecasts were still considerably higher than previous actual expenditure.

Figure 1.3 shows the capex forecasts under the current framework compared to the actual capex under the previous frameworks (in real terms). For all NSPs there has been a step change in capex forecasts under the current chapters 6 and 6A. The AER's final determinations included regulatory forecasts that were on average 64 per cent higher (in real terms) than actual expenditure in the previous period. Four NSP's regulatory capex forecasts are over 90 higher than previous actual expenditure.

Figure 1.3 Electricity transmission and distribution actual (previous period) and forecast capital (current period) expenditure



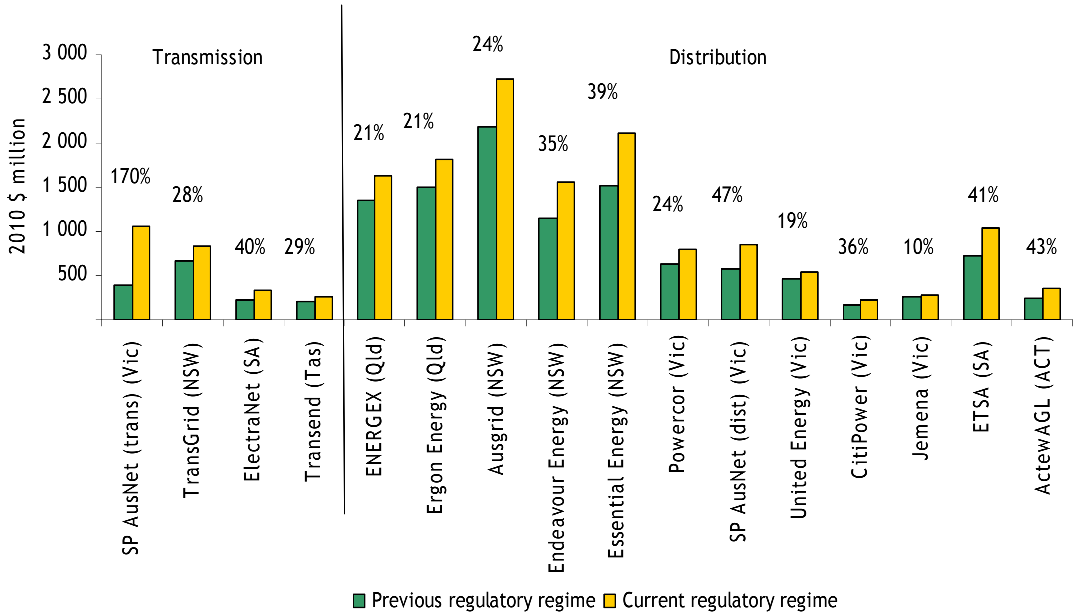
Notes: Figures include capital contributions and do not include adjustments for disposals. Some adjustments have been made to previous period expenditure to align the length of the determination periods.
AusGrid's distribution network includes 962 kilometres of transmission assets.
The Aurora Energy distribution and Powerlink transmission networks are excluded from the figure as the AER is currently in the process of making the first determinations under the current framework for these businesses.

Source: AER and Australian Competition Tribunal regulatory determinations.

There are legitimate reasons for some increases in capex from previous levels. However the sharp and significant step change in expenditure forecasts draws into question whether the current framework is meeting the NEO in 'promoting efficient investment' or whether it is stimulating investment above efficient levels.

Increases in opex have also been significant. On average across all NSPs, opex proposals from NSPs were 34 per cent higher (in real terms) than actual expenditure in the previous period. Half of the NSPs have forecast opex that is at least 35 per cent above levels incurred during the previous regulatory period (Figure 1.4).

Figure 1.4 Electricity transmission and distribution actual (previous period) and forecast operating (current period) expenditure

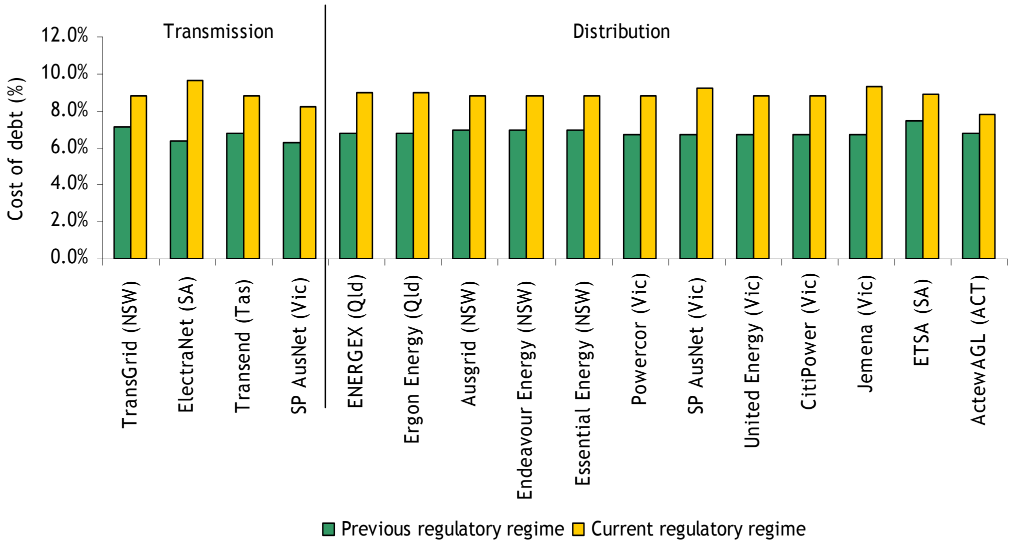


Notes: Some adjustments have been made to previous period expenditure to align the length of the determination periods.
AusGrid's distribution network includes 962 kilometres of transmission assets.
The Aurora Energy distribution and Powerlink transmission networks are excluded from the figure as the AER is currently in the process of making the first determinations under the current framework for these NSPs.
The large increase in SP AusNet's opex forecast in the current period was in part due to the introduction of an easement land tax mid way through the previous period (of approximately $90m per annum)

Source: AER and Australian Competition Tribunal regulatory determinations.

The increases in forecast capex and opex have been accompanied by increases in the allowances for cost of capital, driven primarily by higher debt risk premiums (see Figure 1.5).

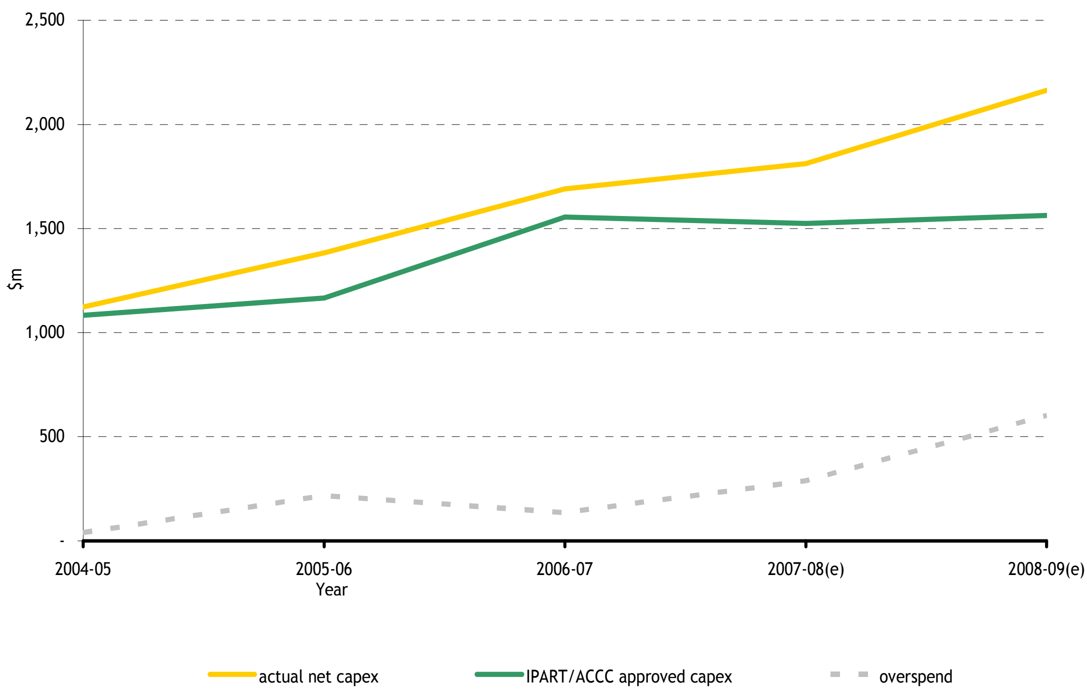
Figure 1.5 Cost of debt approved in previous and current regulatory control periods



Notes: The Aurora Energy distribution and Powerlink transmission networks are excluded from the figure as the AER is currently in the process of making the first determinations under the current framework for these NSPs.
The costs of debt for the Victorian DNSPs are currently subject to merits review by the Australian Competition Tribunal.

Source: AER and Australian Competition Tribunal Regulatory determinations.

Figure 1.6 Combined NSW DNSPs actual and determined capex forecast ($m real 2008–09)



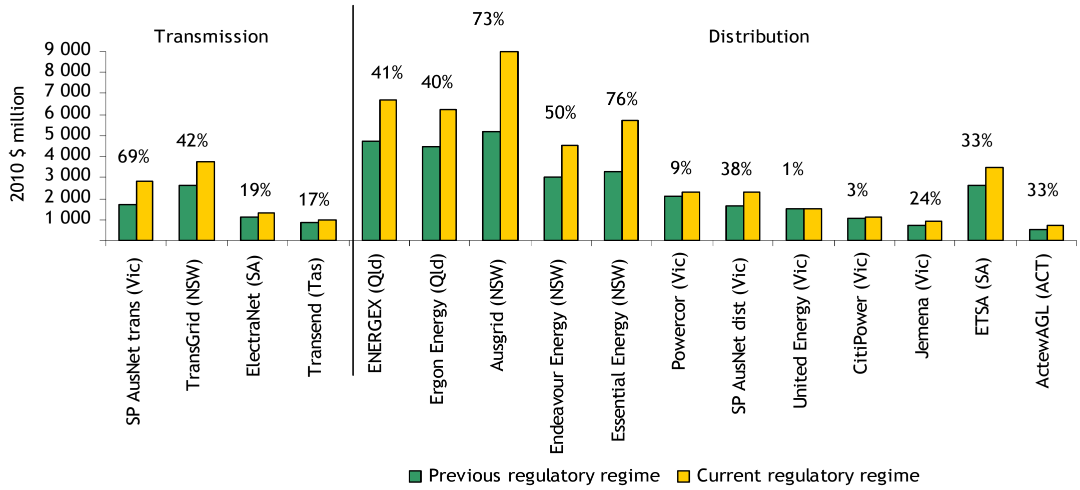
Source: AER, *Draft decision—New South Wales draft distribution determination 2009–10 to 2013–14*, 21 November 2008, p. 123.

In the transition to the new framework, several NSPs spent significantly more in the previous period than was allowed in the corresponding determinations (particularly some DNSPs in Queensland and NSW). For example between 2004–05 and 2007–08, the NSW DNSPs spent 19 per cent more than the forecasts set in previous determinations (Figure 1.6).[20] Around 94 per cent of the total overspend was due to expenditure by AusGrid and Essential Energy.

Capex in excess of forecast has contributed to the step change in the regulated asset base at the start of the new regulatory period and electricity price rises. The AER estimates that up to 25 per cent of increased distribution network charge arising in NSW and Queensland were attributable to capex in excess of that forecast during the previous round of regulatory resets.

The combined increases in forecast capex and opex, step changes in the regulatory asset bases and a higher cost of capital have led to a significant increase in annual revenue requirements in most jurisdictions. Figure 1.7 shows that the amended rules framework has supported significant increases in transmission and NSPs, in all states except for Victoria. Annual revenue increases for the DNSPs in NSW and Queensland have been particularly high, exceeding 60 per cent for all businesses.

Figure 1.7 Approved electricity transmission and distribution revenues previous and current periods



Notes: Some adjustments have been made to previous period expenditure to align the length of the determination periods.
The increase in SP AusNet's approved revenues in the current period was in part due to the introduction of an easement land tax mid way through the previous period.
AusGrid's distribution network includes 962 kilometres of transmission assets.
The Aurora Energy distribution and Powerlink transmission networks are excluded from the figure as the AER is currently in the process of making the first determinations under the current framework for these NSPs.

Source: AER and Australian Competition Tribunal regulatory determinations.

20 AER, *Draft decision—New South Wales draft distribution determination 2009–10 to 2013–14*, 21 November 2008, p. 122.

2.4 AER review of existing framework

In late 2010 the AER commenced an internal review of the operation of the regulatory framework set out in chapters 6 and 6A. The timing of the review reflected the fact that the first round of electricity distribution and transmission determinations under the new framework was almost completed.

The review was targeted at:

- assessing whether the regulatory framework in chapters 6 and 6A was operating well
- reviewing the AER's own processes to identify improvements that can be made within the boundaries of the existing framework set out in the NER.[21]

Many aspects of the existing regulatory framework are operating well. For example, the AER considers that the prescription of key process requirements in the NER for making network determination such as timeframes for consultation and decision making are generally working well. The prescription of this process has delivered certainty to market participants and provided discipline on the AER to deliver timely network determinations.

The AER is continuing to develop its own processes to improve the effectiveness of economic regulation. For example, techniques and tools are being developed for assessment of efficient costs, through targeted information collection and analysis. This work will improve the transparency of NSPs cost drivers, costs and performance outcomes, increasing accountability of the businesses and improving the quality of information for economic regulation.

In the recent Victorian distribution determination, the AER developed a new benchmarking and analysis tool—the repex model—to assess the need for replacement expenditure on ageing assets. The AER is also giving particular attention to benchmarking as a key tool in identifying efficient costs.

While many aspects of the economic regulatory framework for distribution and transmission networks are sound and should be retained, a number of issues have been identified which cannot be addressed under the current chapter 6 and 6A.

3 Statement of issues on existing rules

Services supplied by NSPs are generally supplied under natural monopoly conditions, meaning that these services can be supplied more efficiently by a single service provider. However, this lack of competitive discipline increases the potential for market failure, due to the capacity of NSPs to exercise their market power.

In these circumstances, economic regulation is often introduced to address the costs and inefficiencies that can arise from the exercise of market power. Economic

[21] The AER's internal review did not address the negotiating frameworks contained in rules 6.7 and 6A.9. The AER understands that this framework will be reviewed as part of the AEMC's ongoing Transmission Frameworks Review.

regulation is also generally designed to provide NSPs with incentives for efficient investment in, and operation of, their infrastructure. In so doing, economic regulation should promote the long term interests of consumers and further the NEO.

Regulation will, however, only be able to prevent the inefficiencies arising from the exercise of market power if the regulator is provided with sufficient tools to enable it to do its job effectively. There are limitations in the current chapters 6 and 6A of the NER that do not permit the effective regulation of natural monopoly network businesses. These limitations arose from the codification of both the process and methodology for economic regulation of NSPs under the current chapter 6 and 6A.

The codification of some elements of the process has delivered benefits in terms of timeliness and certainty around decision making. However, the detailed codification of the methodology of economic regulation in chapters 6 and 6A has hindered the AER's ability to appropriately regulate NSPs as monopoly service providers.

It has restricted the AER's ability to effectively balance the interests of both consumers and regulated NSPs when making regulatory determinations and hindered the AER's ability to respond flexibly to changing circumstances. As a result, the AER considers that consumers are paying more than the efficient cost required to maintain a reliable and secure power system.

The problems that have been identified with the current framework can be classed into three main areas:

- the capex and opex framework
- the process for setting capital cost estimates
- the efficiency and transparency of the regulatory process.

Each of the particular areas where issues have been identified are discussed in broad terms below. Further detail, reasoning and analysis are set out in Part B of this proposal.

3.1 Capex and opex framework

It is the AER's view that the current framework for setting forecasts of capex and opex is not promoting efficient outcomes in the long term interests of consumers. Rather, the framework delivers inflated forecasts of capital and operating expenditure and fails to provide sufficient incentives for efficient expenditure.

Forecasting required expenditure

The AER is required under the revenue and pricing principles in the NEL to provide NSPs with a reasonable opportunity to recover at least efficient costs.[22] However, during the development of chapter 6A in 2006, the AEMC formed the view that the general protections afforded by the NEL and NER that prescribe a clear set of

[22] NEL, s 7A (2).

objectives and a transparent process were insufficient to guard against the risk of the regulator setting forecasts of required expenditure below efficient cost.

Instead of relying on these general protections, it was considered necessary to go further than the codification of timeframes and regulatory process and prescribe the AER's decision making framework. The current framework goes beyond affording a reasonable opportunity to recover efficient costs. Indeed, it invites upwardly biased expenditure forecasts and provides the regulator with limited ability to interrogate and amend forecasts proposed by NSPs.

The rules currently require the AER to accept proposals from NSPs if it is satisfied they 'reasonably reflect' efficient, prudent and realistic expenditure. The expression 'reasonably reflects' recognises that there may be more than one expenditure forecast that is efficient, prudent and realistic. Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leaves the evidentiary burden on the AER to prove that the proposed forecast does not reasonably reflect prudent and efficient costs. Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operate to exclude the AER from setting that lower forecast. In an unbiased regime, all answers that meet the requirements of the NEL could be determined. That is not the case under the current rules.

This problem exists for determining forecasts for both transmission and distribution networks. However, the issue is compounded in distribution due to two further restrictions on the AER's discretion under chapter 6.

- determined 'on the basis of' the current regulatory proposal
- amended from that basis 'only to the extent necessary' to enable it to be approved in accordance with the NER.[23]

Accordingly, under chapter 6, if the AER is not satisfied a forecast proposed by a DNSP reasonably reflects the required expenditure, the AER may only amend it to the minimum extent necessary for it to be approved under the rules. The further restrictions in chapter 6 that the AER's response must be determined on the basis of the regulatory proposal also locks the regulator into forming a substitute in the same manner as determined by the DNSP in its proposals.

As most proposals are based on a large amount of engineering detail and a 'bottom up' calculation of the required expenditure, the AER must conduct a line by line analysis in order to reduce the forecast to fall back within the 'reasonable' range. This inappropriately limits the AER's ability to weigh up all available data and determine an impartial forecast. While a line by line assessment of a limited sample of projects would be undertaken in any well functioning regime, it should not be to the exclusion of other 'top down' techniques, like benchmarking. The line by line assessment is also resource intensive and includes consideration of engineering detail which may preclude the involvement of third party stakeholders such as consumer groups.

[23] NER, cl 6.12.3(f).

The AER is not aware of any other regulatory regimes that apply this type of restriction. Box 3.1 summarises alternative regulatory frameworks that are in use in the UK, USA and other Australian jurisdictions. Notably, this restriction did not apply to the AER or ACCC under the SRP as explained in section 2.1.

At the time that the current chapter 6A was written the AER raised concerns regarding potential price impacts resulting from an inappropriate balance between the interests of NSPs and consumers.[24] The experience from the last five years has exemplified the restrictions on the AER's regulatory discretion and in turn suggests that concerns about inflated forecasts were well founded. While it is difficult to quantify the extent to which price rises have exceeded efficient levels, inflated forecasts have been a factor in the price rises faced by consumers.

Some stakeholders, including some NSPs, have observed that the framework is working well as the AER's recent decisions have rejected and substituted capex and opex forecasts. However the forecasts substituted by the AER have still represented significant increases on past expenditure levels. For example, the AER did not allow 11 per cent of total proposed capex across all TNSPs. The forecast capex accepted by the AER still represented a 64 per cent increase (in real terms) on actual expenditure under the previous framework. The AER is not confident that this represents efficient or necessary expenditure.

Efficiency incentives

The current rules require that all actual capex incurred within a regulatory period be automatically rolled into the asset base at the start of the next period. From then, the NSP may earn a return on and of the capital expenditure. This occurs regardless of whether the expenditure is efficient and/or prudent or is greater than forecast.

The introduction of the current RAB roll forward mechanism has coincided with large capital overspends in certain jurisdictions, particularly NSW and Queensland. The roll forward of these overspends has led to significant step changes in prices for consumers. Some industry commentators have suggested that the current arrangements have stimulated excessive investment. For instance, IPART noted that its concern that:

> the current regulatory arrangements may not best meet the NEL objective because they could be promoting investment in excess of efficient levels. Paying higher prices than necessary is not in the long-term interest of customers.[25]

Although the NSP cannot earn returns on the excess expenditure until the start of the next regulatory period, the AER is concerned that the current RAB roll forward mechanism may not, in some circumstances, sufficiently discipline capex in excess of the original forecast.

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24 AER, *Submission: AEMC, Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006*, March 2006, pp. 10–12.

25 IPART, *Changes in regulated retail prices from 1 July 2011—Final report*, June 2011, p. 96.

Box 3.1—Use of discretion by economic regulators

In other jurisdictions, lawmakers have found it appropriate to empower regulators to regulate prices based on their expert judgement, with only high level guidance as to how this should be achieved. For instance:

Great Britain	The relevant legislation confers on the Gas and Electricity Markets Authority (Authority) a principle objective – which is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition – and a number of other duties (such as the need to secure that licence holders are able to finance the activities). Beyond these high level obligations, the Authority is empowered to impose such licence conditions as appear to the Authority to be requisite or expedient having regard to its statutory duties.[26]
United States (transmission)	The Federal Energy Regulatory Commission (FERC) must ensure that transmission charges are just and reasonable and not unduly discriminatory or preferential.[27] The FERC is also obliged to develop an incentive-based regulatory regime which: promotes reliable and economically efficient transmission and generation of electricity by promoting capital investment, provides a return on equity that attracts new investment, encourages deployment of transmission technologies and allows recovery of all prudently incurred costs.[28] Beyond these high level obligations, FERC has scope to set allowances as it sees fit, subject to judicial-style regulatory proceedings.
Victoria (prior to current rules)	The Essential Services Commission (ESC) has a primary duty - to protect the long term interests of Victorian consumers with regard to the price, quality and reliability of essential services – and a number of further duties, including to facilitate efficient investment in, and the financial viability of, regulated industries.[29] In addition, the Tariff Order issued under the *Electricity Industry Act* required the ESC, among other things, to utilise price based regulation adopting a CPI-X approach, and not rate of return regulation. Within this framework, the ESC had broad discretion to make its own decision on the most appropriate methodology for determining regulatory allowances.
Other NEM jurisdictions (prior to current rules)	Elsewhere in the NEM, jurisdictional regulators including IPART regulated DNSPs in accordance with the National Electricity Code (the predecessor to the NER).[30] Regulators were required to seek to achieve the objectives, in accordance with the principles, of the Code.[31] The Code was more prescriptive than the other regimes discussed here, the level of detail fell far short of the current rules. The Code did not prescribe the regulators' decision-making process.

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26 *Electricity Act 1989* (UK), ss 3A(1) and 7(1).

27 *Federal Power Act* (US), s 205.

28 *Federal Power Act* (US), s 219.

29 *Essential Services Commission Act 2001* (Vic), ss. 8, 14, 30, 32, 33 and 35.

30 Subject to various derogations.

31 National Electricity Code, clauses 6.10.2 and 6.10.3. See IPART, *Regulatory arrangements for the NSW DNSPs from 1 July 2004 – Issues paper*, November 2002, Appendix 1.

3.2 Process for determining the cost of capital parameters

There are two broad categories of issues with the current rules for setting the weighted average cost of capital (WACC):

- the process, method and timing for determining the WACC, including the role of ‘persuasive evidence’ in the energy framework
- the method of setting the debt risk premium.

Determining the WACC

At present, there are three different processes to determine the WACC for electricity networks and gas pipelines:

- In electricity transmission, a WACC review is undertaken at fixed five yearly intervals. The parameters determined during the WACC review must then be applied to each subsequent electricity transmission determination, with no ability to depart from the parameters that were determined during the review. The NER require that during the WACC review, the AER must have regard to the ‘need for persuasive evidence’ before changing a previously applied value or method.
- For electricity distribution determinations, a WACC review must be undertaken at least once every five years. The parameters published in this review can be departed from when making a distribution determination for each individual DNSP if there is ‘persuasive evidence’. In practice a determination is made on the WACC parameters applying to each DNSP as part of each distribution determination. While it is the role of the AER to determine whether there is persuasive evidence, DNSPs have the right to contest that there is sufficient persuasive evidence. Decisions on whether there is persuasive evidence form part of the distribution determination and are therefore subject to merits review by the Australian Competition Tribunal.
- For gas pipelines, the National Gas Rules do not set out any particular approach to setting the WACC, and the AER is required to reassess its approach and any relevant parameters every time it conducts a determination.

The approaches applying to DNSPs and gas pipelines have been problematic. Both of these approaches have required the continual assessment of similar arrangements and evidence at each determination process, either in determining the parameters themselves or determining whether there is persuasive evidence to depart from the WACC review.

In electricity distribution the framework has led to an ongoing ‘WACC review’ for various parameters at each distribution determination, with high administrative burden in reconsidering parameters which, by their nature, should not change over the short to medium term.

Furthermore, the ‘need for persuasive evidence’ in the WACC review is unnecessary. The test affords undue weight to previous outcomes rather than permitting the regulator to set appropriate methods or values for WACC parameters considering all relevant factors, including previous determinations.

Definition of the debt risk premium

The current rules codify the form of the benchmark that must be used to assess the cost of debt—an Australian benchmark corporate bond rate with a maturity of the same length as used in calculating the risk free rate. This benchmark is problematic under changing debt conditions where there are limited issues of such a long dated corporate bond in Australia. There is also concern as to whether this benchmark definition reflects efficient financing practices of NSPs.

3.3 Efficiency of the regulatory process

The current process for regulatory decisions involves a number of steps, starting with a framework and approach paper (for distribution), the NSP submitting its proposal, a draft determination, the submission of a revised proposal and a final determination. At each of these stages, the NER provide minimum amounts of time that stakeholders must be given in which to provide their views.

There are a number of areas where the regulatory process can be improved to allow stakeholders to more effectively engage in the process. Firstly, NSPs are permitted to provide submissions on their own proposals, which the AER must consider when making its determination. Many NSPs have submitted regulatory proposals and then followed with lengthy submissions on their own proposals with significant additional information. This is inconsistent with the AEMC's original intention that the framework should require NSPs to provide fully formed proposals at the outset.[32]

This practice has also presented barriers to effective stakeholder engagement. Due to the time constraints placed on the process and the absence of information in the regulatory proposal, there is often insufficient time for stakeholders to be afforded the opportunity to comment on NSPs submissions. Further, the practice limits the amount of time available for stakeholders and the AER to robustly analyse the additional information.

Secondly, for DNSPs, the AER must prepare a framework and approach paper before the network determination process starts which sets out the likely approach to the application of various incentives schemes. The AER's conclusions on the schemes are not binding during the determination process and to date there has been limited engagement from stakeholders in this process.

Thirdly, the manner in which the AER should treat confidential information received from NSPs as part of the *proposals* should be consistent with the treatment of confidential submissions from other stakeholders.

The NER provide the AER with the discretion to 'give such weight as it considers appropriate' to confidential information it receives in *submissions* having regard to

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32 AEMC, *Draft Rule Determination – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, 26 July 2006, p. 109 (*Draft Rule Determination*); AEMC, *Rule Determination*, 16 November 2006, p. 110.

the fact that the information has not been publicly available. This provision was included in the NER in recognition that it is essential that there is a degree of transparency surrounding the contents of all submissions considered by the AER.[33] The discretion provided to the AER also arguably provides an incentive to restrict confidentiality claims.

There is no equivalent provision for confidential information received in NSPs' *revenue proposals* or *revised proposals*. The AER does not have the ability to determine the weight that should be afforded to this information in light of the lack of opportunity for stakeholders to scrutinise and comment on the information. While some information received as part of a regulatory proposal will truly be commercially sensitive and may still be critical in the AER's determination, the AER should be able to assess the weight that should be given to that confidential information (as is the case with confidential submissions).

There are several other regulatory process issues which are outlined in Part B including the process for revoking and substituting decisions where a material error has been identified and setting the service classification and form of control for electricity networks.

4 Description of proposed rule change

This rule change proposal has been developed as an integrated package to address the deficiencies that were highlighted in the previous section. The package carefully balances the interests of NSPs and electricity consumers.

The key changes outlined in the rule change package relate to:

- Capex and opex framework—the process by which the AER develops forecasts of efficient capex and opex and the incentives on electricity networks to spend no more than is necessary and efficient
- WACC—the process for setting the cost of capital
- The regulatory process—streamlining the regulatory determination process and ensuring stakeholders are effectively engaged and have the opportunity to robustly analyse material from NSPs.

Each of these changes are discussed in broad terms below with further detail set out in Part B. The package also includes a number of other recommendations that relate to shared assets and implementing the proposed framework. These proposals are also set out in Part B.

4.1 Capital and operating expenditure framework

Forecasting required expenditure

This rule change proposal balances the need for a clear, transparent and predictable framework to ensure that NSPs have a reasonable opportunity to recover at least the

33 AEMC, *Rule Determination*, 16 November 2006, p. 121.

efficient cost of providing a safe and reliable service, while ensuring that consumers are not exposed to the risk of systemically inflated expenditure forecasts. This will promote both the long term interests of consumers and be consistent with the revenue and pricing principles in the National Electricity Law.

The proposed rule change:

- amends the decision making test to require that the AER must determine the forecast of expenditure that the AER considers a prudent and efficient NSP would require to provide a safe and reliable electricity service
- removes the restrictions that limit the AER's ability to determine an impartial forecast
- enhances the mechanisms available to manage uncertainty in the determination of forecasts.

These changes would allow the AER to effectively scrutinise the material provided by NSPs and undertake an impartial assessment of forecast efficient costs thereby achieving the NEO.

Amendments are also proposed for the current prescribed 'factors' and 'criteria' that must be taken into account when making a determination. The current set of factors include a mix of procedural and substantive matters, but it is not clear whether the list is intended to be exhaustive, or how the regulator should manage conflicting factors. The AER proposes the prescribed 'factors' be simplified, by separating procedural from substantive matters.[34] The AER also proposes amending the 'criteria' that should be considered when setting forecasts of efficient capex and opex.

Incentives to spend within expenditure forecasts

Under the proposed rule changes, where an NSP spends more than the original forecast over the course of a regulatory period, a sharing mechanism would apply to the overspend. 60 per cent of any capex overspend would be added to the asset base at the next regulatory period, with the remainder funded by shareholders, that is with no return on or of capital. This mechanism would strengthen the incentives on NSPs to incur no more than the approved forecast.

In developing this proposal, the AER considered a range of options for increasing the power of the capex incentive. The National Gas Rules utilise an ex post prudency assessment prior to rolling capex into the asset base at the start of the next regulatory period. This was also allowed under the earlier versions of chapter 6 of the National Electricity Code.

The AER has decided not to propose ex post capex reviews as it considers that it is more appropriate to reduce the risk of businesses overspending by addressing the underlying incentives for overspending. The proposed amendment will effectively reduce this risk.

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[34] These factors are (1) building block proposal information (2) submissions received and (3) analysis undertaken by the AER and published before/with the determination.

Changes are also proposed to the basis of depreciation calculations, and the process for determining what types of expenditure are considered to be capex. A new mechanism is also proposed that would provide the AER greater flexibility to develop incentive schemes. This would allow the framework flexibility to keep pace with developments in regulatory best practice, without the need for further changes to the NER.

Additional measures for dealing with uncertainty

The AER recognises that there may be occasions where NSPs need to efficiently spend more than the forecast amount due to unforeseen changes in circumstances. To address this, the rule change proposal contains enhanced measures to deal with the risks associated with uncertainty.

Specifically, the proposed rule changes:

- include a reopener provision for distribution determinations to allow the capex elements to be reopened in certain circumstances
- introduce a contingent projects framework for DNSPs
- amend the materiality threshold applying to DNSPs under the cost pass through provisions to align it with the arrangements for TNSPs (to 1 per cent of revenues).

4.2 Process for determining cost of capital parameters

A single regime is proposed for calculating the WACC to apply to gas and electricity NSPs. A separate rule change is also proposed to the National Gas Rules to implement this regime.

Under the proposed rule the WACC review would be undertaken at least every five years, with discretion for the AER to initiate earlier reviews. The parameters (or methodologies) determined during the WACC review would apply to each NSP's revenue determination, as is currently the case under chapter 6A. This proposal streamlines the current process for setting the WACC parameters and provides certainty in setting the WACC for NSPs and consumers.

The proposed removal of the persuasive evidence test to apply at the time of each WACC review will provide more flexibility for the AER to deal with changing market circumstances while still ensuring the importance of previously adopted values is taken into account.

The changes also seek to prevent undesirable outcomes when setting debt risk premium. The factors relevant to determining the debt risk premium, and the definition of this benchmark would be determined through consultation during the WACC review, rather than prescribed in the NER.

4.3 Regulatory processes

This proposal includes amendments that streamline the regulatory process and ensure that all stakeholders have the opportunity to robustly analyse material from NSPs.

In particular:

- NSPs would not be able to make submissions on their regulatory proposals or on the AER's draft decision (but NSPs would retain the option to submit revised proposals in response to the AER's draft decision)
- the AER would be given the discretion to give 'such weight as it considers appropriate' to confidential information contained in regulatory proposals, given that the information has not been made publicly available. This is consistent with the treatment of confidential information contained in submissions from other stakeholders
- the framework and approach process would also be amended to remove the requirement for consultation on the various schemes at this early stage of the process (consultation on these schemes will still occur later in the determination process).

5 Assessment of the proposed rule against the national electricity objective

5.1 Legal framework

The NEL sets out the framework the AEMC must apply when considering a proposal for a rule change.[35]

The AEMC may only make a rule if it is satisfied that the rule will or is likely to contribute to the achievement of the NEO. The AEMC may give weight to any aspect of the NEO as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.[36]

The AEMC must also take into account the revenue and pricing principles in the NEL in making a Rule with respect to distribution and transmission system revenue and pricing or regulatory economic methodologies.[37] Broadly the revenue and pricing principles are concerned with:[38]

- allowing distribution and transmission network service providers a reasonable opportunity to at least recover their efficient costs
- providing effective incentives to promote efficient investment in the transmission and distribution networks
- providing certainty with regard to value of previous investments (in particular the value of the existing regulatory asset bases)

35 NEL, Part 7, Division 3.
36 NEL, s 88.
37 NEL, s 88B and Schedule 1, items 15–26J.
38 NEL, s 7A.

- providing returns commensurate with the regulatory and commercial risks associated with investment in the transmission and distribution networks

- having regard to the costs and risks associated with under and over investment and utilisation of the distribution and transmission networks.

5.2 How the proposed rule contributes to the national electricity objective and revenue and pricing principles

The proposed rule changes will contribute to the achievement of the NEO by promoting efficient investment in, and efficient operation of, electricity networks in the long term interests of consumers.

This section outlines how the proposed rule changes contribute to the NEO and the revenue and pricing principles. More detail on how each proposed rule satisfies the NEO and the revenue and pricing principles is outlined in Part B.

Balance

The proposed rules provide the AER with the necessary tools to allow it to more effectively balance the interests of consumers and the need for investment in electricity networks when making regulatory determinations. For example, the proposed amendments to the process for determining forecasts of capex and opex ensure that the regulator is more able to properly scrutinise, assess and amend proposed forecasts of required expenditure.

Incentive regulation

The rule change proposal is designed to implement more effective incentives for efficient investment in and the operation of NSPs. The proposed rules provide a balanced approach between providing incentives to achieve cost efficiencies with appropriate incentives to maintain service quality and reliability. For example, the proposed RAB roll forward provisions encourage NSPs to invest only when it is efficient and prudent to do so. This mechanism also encourages NSPs to more appropriately consider the balance between capex and opex and between short term and long term investments.

Innovation

The rule change proposal provides for a more innovative and responsive regulatory framework which permits the regulator to effectively respond to change or unique and unforseen circumstances that may arise. This will diminish the risks to network businesses and consumers associated with undesirable outcomes arising from the application of highly prescriptive rules and methodologies. For example, the proposed rules allow the AER to respond to any significant changes in circumstances and initiate reviews of WACC parameters prior to each five year interval. The proposed amendments to the capex and opex factors allow greater use of innovative regulatory techniques, such as greater use of benchmarking.

Certainty

Chapters 6 and 6A of the NER would continue to provide significant certainty about the regulatory framework to encourage timely and efficient development of network capacity. Key aspects of the regulatory decision making framework, such as the timeframes for regulatory decision making, remain locked in under the amendments. The proposed rules also provide up-front certainty about the treatment of capex and opex. In particular, no ex post review of capex is proposed.

Minimised administrative costs

The rule change proposal is designed to minimise the administrative costs for NSPs, consumers and the AER associated with regulatory decision making. The potential for minimised administrative costs is evident in many elements of the proposed rule changes. For example, the proposal to align WACC review provisions across transmission and distribution would minimise administrative costs. Under the proposed arrangements, there would be a periodic review of the WACC, rather than the current process whereby WACC arguments are continually reviewed in distribution.

Finally, the package of proposed rule changes will deliver outcomes that are consistent with the revenue and pricing principles. The proposals provide effective incentives to promote efficient investment while also catering for uncertainty. The balance of mechanisms provided in the rule change proposal will more effectively protect consumers from the risk of inefficient investment, while ensuring that NSPs have the opportunity to recover at least efficient cost.

5.3 Statement of benefits and costs

The package of proposed amendments to chapters 6 and 6A of the NER provides an appropriate and proportionate response to the issues that have been identified. While the rule changes may not be supported by all market participants in the NEM, the overall package will more effectively balance the interests of all those affected by network determinations.

This section outlines the expected costs, benefits and impacts of the rule change package on various parties at a high level. More detail on expected costs, benefits and impacts of the rule change package is outlined in Part B.

NSPs

The proposed rule amendments preserve key aspects of the current framework for electricity network regulation including the incentive based (CPI-X) regulatory regime and the building block approach to determining allowed revenues. The relatively incremental nature of the proposed amendments will minimise many of the risks for NSPs associated with regulatory change and uncertainty. To the extent that the rule change package confers additional discretion on the regulator, that discretion is constrained by principles in the rules and the NEL.

Several of the amendments will also provide greater investment certainty to network businesses. For example, extending the codification of WACC review outcomes and providing a consistent approach to setting the regulated rate of return across regulated NSPs will assist in providing a positive environment for capital raising.

The proposed amendments also deliver benefits to NSPs. For example, the proposed inclusion of a contingent projects regime for distribution provides a framework more capable of dealing with uncertainty and will assist a NSP to spend more than forecast where it is efficient. Further, the streamlining of regulatory processes, such as the process for determining WACC, has the potential to reduce administrative costs for NSPs.

Nevertheless, there may be some costs experienced by NSPs associated with the proposed package of amendments, particularly where the rule change is targeted at NSPs that do not contain capex within the forecast amount. In particular, the proposed RAB roll forward mechanism would affect the returns that NSPs currently earn on any additional capex in excess of forecast.

Consumers

The rule change proposal has been designed to introduce measures to address the inability of the AER to determine efficient costs, noting that it is consumers that are required to pay for any expenditure beyond efficient levels. The rule change proposal introduces more effective incentives for efficient investment in and the operation of transmission and distribution networks. The rule change also seeks to protect consumers against inefficient underinvestment in networks and any resulting reliability implications. In particular the introduction of new mechanisms to deal with the risks associated with uncertainty, such as the contingent project and reopener provision in distribution will allow DNSPs to invest more than forecast where it is efficient.

The rule changes also reduce administrative costs and allow for more innovative regulation. In so doing, the rule change proposal is designed to deliver a more appropriate balance between the interests of NSPs and consumers than is evident under the current regulatory framework.

The major beneficiaries of the proposed rule changes are electricity consumers. Measures to promote more efficient expenditure in electricity networks promote the interests of electricity consumers by providing network services at a more efficient cost. The RAB roll forward sharing mechanism to be applied to capex overspends will also benefit consumers by providing strong incentives for NSPs to incur only efficient expenditure. This will assist in mitigating future step changes in prices that have previously occurred at the commencement of new regulatory periods where the NSP has spent more than its previous capex forecast. Providing incentives for efficient capex in electricity networks may also benefit other electricity market participants, such as generators and demand side participants who provide services that operate as substitutes for network investment.

AER

The major benefit for the AER is in the streamlining of some regulatory approaches, such as establishing a single process for determining the WACC. Streamlining these approaches will allow the AER to redeploy current resources to improve and develop new regulatory tools and techniques. For example the AER could commit greater resources to developing models that utilise benchmarking to assist in assessing NSP’s capital and operating expenditure forecasts.

PART B – DETAILED RULE PROPOSALS

6 Capex and opex framework

6.1 Introduction

The current network regulatory framework contains a set of clear and transparent objectives contained in the National Electricity Law (NEL). These objectives, together with appropriate information gathering powers for the regulator, are the foundation of a well functioning economic regulatory framework.

However, during the development of chapter 6A in 2006, the AEMC formed the view that the general protections afforded by prescribing a clear set of objectives and a transparent process were insufficient to guard against the risk of the regulator setting forecasts of required expenditure below efficient cost.

Instead of relying on these general protections, it was considered necessary to go beyond the codification of timeframes and regulatory process to prescribe the AER's decision making framework. In particular, the process for determining forecasts of required capex and opex are prescriptive and include significant limitations on the regulatory judgement that can be exercised relative to what was available to previous jurisdictional regulators and the ACCC. Box 3.1 provides examples of the approach that other jurisdictions have used when setting limits on regulatory discretion.

The AEMC considered that there was no one 'right' cost estimate and that the best way to avoid the risk of regulatory error was to set limits on the exercise of discretion. This was contrary to evidence available at the time that regulators like the ACCC were conscious of the asymmetric nature of the regulatory risk.[39] In addition, the revenue and pricing principles in the NEL themselves require that NSPs be afforded a 'reasonable opportunity to recover at least the efficient costs the operator incurs'.[40]

Submissions at the time noted that the framework proposed by the AEMC would strike an inappropriate balance between the risk of price impacts on consumers and the risk of forecast errors. Nevertheless, the new provisions required that the regulator must accept the NSP's proposal if satisfied it 'reasonably reflects' required expenditure. The expression 'reasonably reflects' recognises that there may be more than one expenditure forecast that is efficient, prudent and realistic. Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leaves the evidentiary burden on the AER to prove that the proposed forecast is not efficient and not prudent. Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operate to exclude the AER from setting that lower forecast.

This problem is further compounded for DNSPs due to two further restrictions on the AER's discretion under chapter 6. Under chapter 6, if the AER considers a forecast

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39 Asymmetric risk refers to the negative consequences of under investment from setting forecasts below actual costs being far greater for consumers than the costs of a moderate over stimulus of investment.

40 NEL, s 7A(2).

proposed by a DNSP is too high, it can only amend the proposed forecast to the minimum extent necessary for it to be approved under the rules.

In addition, any substitute forecast determined by the AER must be based on the original proposal. In an environment where forecasts proposed by DNSPs are routinely constructed using a bottom-up, project-by-project approach, the AER has found it necessary to also use a line by line 'bottom-up' approach to assessing forecasts. This restriction undermines the AER's ability to conduct top-down benchmarking approaches, together with assessing matters such as the deliverability of the proposed expenditure. Although the NER contemplates the use of benchmarking, the AER has found it difficult to put these provisions into practice since it must be able to justify each decision to deviate from the DNSP's proposal.

This rule change proposal addresses both the overarching 'reasonably reflects' issue, together with the specific issues relating to chapter 6. In total, the changes redress the balance between ensuring that the framework provides for sufficiently clear and transparent objectives, while ensuring that consumers are not exposed to the risk of systemically inflated forecasts. This will promote both the long term interests of consumers and allow transmission and distribution networks the opportunity to recover at least efficient costs, consistent with the national electricity objective (NEO) in the NEL.

6.2 Setting estimates of required expenditure

6.2.1 Current rules

The current framework for assessing proposed forecasts of required expenditure requires that the AER accept a proposal if it is satisfied that the forecast 'reasonably reflects' the expenditure criteria.[41] Each expenditure criterion is in turn directed to achieving each of the expenditure objectives. The expenditure criteria and the expenditure objectives are the same in both chapters 6 and 6A.

By way of example, the opex criteria are:

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

(2) the costs that a prudent operator in the circumstances of the relevant *Distribution Network Service Provider* would require to achieve the *operating expenditure objectives*; and

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

Additionally, the opex objectives are to:

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

41 NER, cll 6.5.6(c), 6.5.7(c), 6A.6.6(c) and 6A.6.7(c).

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

(3) maintain the quality, reliability and security of supply of standard control services

(4) maintain the reliability, safety and security of the distribution system through the supply of standard control services. [42]

In determining if the AER is satisfied and in forming the substitute where it is not, the AER must have regard to the expenditure factors. In chapter 6, the AER's discretion is further limited to amending the forecast:

- 'on the basis of' the current regulatory proposal'
- 'only to the extent necessary' to enable it to be approved in accordance with the rules.[43]

6.2.2 Nature and scope of issues with the current rules

There are three related issues with the current rules:

- the requirement that the AER accept a forecast if it 'reasonably reflects' the required expenditure
- the limits on the regulator amending a proposed forecast only to the extent necessary to make it fall within the range that 'reasonably reflects' the required expenditure (applies only to chapter 6)
- the requirement that the regulator must base any substitute on the original regulatory proposal (applies only to chapter 6).

AER must accept if satisfied forecast 'reasonably reflects'

The expression 'reasonably reflects' recognises that there may be more than one expenditure forecast that is efficient, prudent and realistic. Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leaves the evidentiary burden on the AER to first prove that the proposed forecast is not efficient and not prudent. Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operate to exclude the AER from setting that lower forecast.

This problem exists for determining forecasts for both transmission and distribution networks. However, the issue is compounded in distribution where the 'reasonably reflects' provisions operates together with the restrictions on the AER's response to a proposal, as discussed below.

This experience was foreshadowed by the Expert Panel (2006)[44] which noted that, given the choice of proposing an estimate within a range, the regulated entity will not

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42 NER, cll 6.5.6(a), 6.5.7(a), 6A.6.6(a) and 6A.6.7(a).

43 NER, cl 6.12.3(f).

44 Expert Panel On Energy Access Pricing, *Report to the Ministerial Council on Energy,* April 2006.

opt for other than its estimate of the upper bound of the range.[45] While the Expert Panel also recognised that NSPs are at an advantage as to the understanding of their future expenditure needs, it noted that this should not lead to a conclusion that it is appropriate to create a presumption in favour of accepting an NSP's proposal.[46]

An objective of the AEMC and the MCE[47] in drafting these provisions was to recognise concerns of some stakeholders that regulators might attempt to achieve a level of precision in setting forecasts rather than recognising that there is a range of possible outcomes.[48] Further, it was considered that in order to promote investment consistent with network reliability, it was necessary to codify that the AER must accept NSPs' proposed expenditure forecast where they satisfy specified criteria.[49]

However, it was not recognised that by limiting the exercise of regulatory discretion and creating a presumption in favour of the NSPs' proposals, there was a risk the framework would focus too heavily on the promotion of investment, rather than promotion of efficient levels of investment. As a consequence, consumers have been exposed to the risk of systemically inflated forecasts.

As was noted by the AER in 2006, while it is recognised that there may be a range of likely outcomes, the framework proposed by the AEMC lacked balance and increased the potential for regulatory gaming.[50] However, it is not clear that the analysis undertaken at the time accorded sufficient weight to the likely impact on consumers.

The AER recognises that the consequences of an under-estimate of required expenditure—which could threaten security of supply—are potentially severe. Indeed the National Electricity Law requires the AER to ensure that electricity network businesses have a reasonable opportunity to recover *at least* efficient costs.[51] However, the attempt in the current framework to codify this outcome has led to upwardly biased expenditure forecasts when compared to other more widely used regulatory models.

Restrictions on AER forming a substitute

The restriction in chapter 6 that the AER must only amend the proposal to the extent necessary to make it capable of being approved under the rules, limits the flexibility to weigh up all available information, evidence and data to determine a forecast. If a

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45 ibid., p. 78.

46 ibid., p. 84.

47 AEMC, *Rule Determination*, 16 November 2006; AEMC, *Draft Rule Determination*, 26 July 2006. Chapter 6 was introduced after chapter 6A by the MCE. In developing chapter 6, one objective was to develop a consistent approach to the regulation of electricity networks, as appropriate. Chapter 6 was therefore largely based on chapter 6A: see Standing Committee of Officials of the Ministerial Council of Energy, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution*, Explanatory Material, April 2007. Relevantly, chapter 6 adopted 'the same decision model for approving capex and opex' in chapter 6A: see Standing Committee of Officials of the Ministerial Council of Energy, *Changes to the National Electricity Rules*, April 2007, p. 13.

48 AEMC, *Draft Rule Determination*, 26 July 2006, pp. 41–45.

49 AEMC, *Rule Determination*, 16 November 2006.

50 AER, *Submission: AEMC, Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006*, March 2006, pp. 10–12.

51 NEL, s 7A(2).

proposal is submitted outside of the top of the range that the AER is satisfied 'reasonably reflects' the required expenditure, the AER has found it necessary to conduct a line by line assessment in order to bring it back into the very top of the range. This means that there is no other possible result than an estimate that is at the top of the range. In a more balanced and unbiased regime it would be expected that all possible answers that meet the requirements of the NEL could be determined. That is not the case under the current rules.

The second restriction that the substitute must be formed on the basis of the DNSP's proposal, locks the regulator into forming a substitute in the same manner as determined by the DNSP in their proposal. As most proposals are based on a large amount of engineering detail and a 'bottom up' calculation of the required expenditure, the AER must conduct a line by line analysis in order to reduce the forecast to fall back within the 'reasonable' range.

While a line by line assessment of a limited sample of projects would be undertaken in any well functioning regime, it should not be to the exclusion of other 'top down' techniques, like benchmarking. The line by line assessment is resource intensive and includes consideration of engineering detail which may preclude the involvement of third party stakeholders such as consumer groups.

In addition, as previously acknowledged by the ESCV, a bottom-up approach tends to overstate required expenditure. In its last electricity distribution price determination, the ESCV further stated:

> When expenditure is considered in aggregate, overlaps in projects are identified, and projects are prioritised to reflect the resource (labour, machinery and financial) constraints. This is similar to the budgeting process within a large organisation where the individual budgets of business areas tend to be reduced when aggregated at the company level as the needs of the organisation are prioritised.[52]

Further, the current restrictions that the substitute can only be amended after a line by line assessment of the proposal create a very high evidentiary burden in an environment where there are clear information asymmetries. For example, in the recent AER decision for the Victorian DNSPs, the review of the augmentation (reinforcement) capex forecast was informed by a detailed examination of around 30 per cent of each DNSP's proposed expenditure. The service providers then submitted additional information on the projects reviewed by the AER's consultant.[53]

The projects amenable to examination in detail are dominated by higher value projects, with proportionately greater numbers of supporting documents. This level of detailed assessment was not an outcome envisaged by the AEMC, rather it considered that the AER would be able to readily test the information provided at a high level.[54] However, given restrictions in the current rules, such high level assessments cannot be applied effectively. In the case of the Victorian DNSPs, the AER was only able to apply an adjustment to the 30 per cent of proposed augmentation capex that had been

52 ibid.

53 AER, Final decision, *Victorian electricity distribution service providers, Distribution determination*, October 2010, pp. 424 and 425 and Attachment P, pp. 522–560.

54 AEMC, *Rule Determination*, 16 November 2006, p. 53.

examined in detail. Since it is not realistic for the AER to examine each individual cost incurred by an NSP over a five year period, it is inevitable that a proportion of costs escape regulatory scrutiny.

Finally, only assessing proposed expenditure through a bottom-up approach is inconsistent with the current incentive framework. Currently, NSPs are incentivised to provide the required service levels using whatever mix of expenditure is most efficient, rather than being bound to a specified list of projects. This approach allows NSPs to efficiently prioritise expenditure consistent with changing priorities and circumstances over the regulatory control period. The current restriction to a line by line approach undermines this incentive framework.

6.2.3 Proposed rules

The proposed rules amend the decision making test to require that the AER determine the forecast of required expenditure that the AER considers would meet the efficient costs that a prudent NSP would require to achieve the opex objectives. This clause would be applied as appropriate to both capex and opex forecast in both chapters 6 and 6A. In addition, the provisions that limit the AER's consideration of the regulatory proposal are deleted under this proposal.

Some stakeholders refer to the current model as 'propose-respond' in nature, whereas the AER's proposal is more aligned with a 'consider-decide' framework. The AER does not believe it is particularly helpful to use these labels to describe the proposed changes. In practice, the regulatory process will still begin with a proposal from the NSP, which the AER will use as a base. Nothing in this rule change proposal changes that approach. Rather, this proposal gives the AER the ability to interrogate NSPs' revenue proposals and where necessary to determine appropriate substitute amounts.

Table 6.2 Summary of proposed rule change: AER to determine the forecast of required capital and operating expenditure

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.1] [6.8] [6A.1] [6A.8]	6.5.6(c), (d) 6.5.7(c), (d) 6A.6.6(c), (d), (f) 6A.6.7(c), (d), (f)	6.5.6(c) 6.5.7(c) 6A.6.6(c) 6A.6.7(c)	Revision to: – remove the requirement that the AER is to accept or reject the NSP's proposed opex or capex; – remove the opex and capex criteria; and – provide that the AER is to determine the forecast that it considers would meet the efficient costs that a prudent NSP would require to achieve the objectives.
[10.1] [10.3]	See Part C, Table 3.1	See Part C, Table 3.1	Revisions to remove definitions of capex and opex criteria.

Note: This table is a summary, the complete set of proposed rule are set out at Tables 1.1 and 2.1 in Part C. Consequential revisions to the relevant definitions in Chapter 10 are set out at Table 3.1 in Part C.

6.2.4 How the proposed rules address the identified issues

The proposed rules require the AER to determine the forecast of required efficient expenditure and removing the limitations on the determination of a substitute amount.

These changes do not fundamentally alter the conduct of a regulatory reset process. Rather, as per the outline in Box 6.1, this proposal strengthens the AER's ability to interrogate a revenue proposal and where necessary determine a substitute forecast taking into account a range of information.

These rule change proposals will allow the regulator to continue to develop innovative tools and techniques to assess the efficiency of cost estimates and utilise these in the determination of the expenditure forecasts. This will allow a mix of assessment techniques including individual project assessments and sampling to assess their efficiency, together with 'top down' techniques such as benchmarking. In the event that the AER considers that the forecast overstates required expenditure, this proposal would allow the AER to determine its own impartial forecast.

Box 6.1—How would the AER determine forecast expenditure?

In many respects the current process would remain unchanged. The AER would adopt an open and iterative process involving consultation documents, public forums and bilateral meetings.

In the preliminary stages of the review, the AER would publish a framework and approach paper (under chapter 6) and develop, in consultation with relevant NSPs, a regulatory information notice and information templates which require NSPs' proposals to be submitted in a consistent format.

Following receipt of the NSP's proposals, the AER would assess the information submitted relative to the expenditure objectives set out in the NER. In order to ensure that its assessment is robust, the AER would expect to review NSPs' forecasts using a range of different techniques. These techniques could include top-down benchmarking, bottom-up modelling, activity based analysis, a detailed review of a sample of projects and/or an expert review of costs. In particular, the AER would expect to make greater use of benchmarking than has been the case in its determinations to date. The draft decision would be based on a comprehensive consideration of all the issues, having regard to the results of the various analytical techniques.

The AER would publish its draft decision, NSPs would be able to submit a revised proposal and interested parties would have the opportunity to submit comments. The AER would base its final decision on comments received, further analysis of the NSPs' revised proposals and any other relevant information.

This approach better aligns with the concept of an overall expenditure forecast, which provides the NSPs with the flexibility to run their businesses in the most efficient manner, while ensuring that obligations to customers are still met. As noted by the ESCV in its distribution determination (2005) for the Victorian businesses, assessing projects at an aggregate level rather than project by project results in outcomes consistent with budgeting processes within large organisations. That is, when aggregated at the organisation level, the needs of the organisation drives project prioritisation which results in some projects being delayed or deferred.[55]

Taken as a package, this proposal addresses the issues identified above, and allows for efficient expenditure while still being completely consistent with the NEL revenue and pricing principles that require that all NSPs be afforded a reasonable opportunity to recover at least efficient cost.

6.3 Expenditure objectives, factors and criteria

6.3.1 Current rules

Expenditure objectives

As outlined in section 6.2.1, the expenditure objectives state the matters that the proposed expenditure is to achieve. This includes expenditure required to 'maintain' levels of reliability and 'comply with all applicable regulatory obligations or requirements.'

Expenditure criteria

The expenditure criteria set out the matters that the AER must be satisfied an NSP's proposal, or the AER's substitute of required, expenditure reasonably reflects.[56] An example of the opex criteria was also set out in section 6.2.1.

Expenditure factors

The expenditure factors list the matters that the AER must have regard to when determining whether or not it is satisfied that the proposed forecast reasonably reflects the required expenditure. The factors for distribution and transmission capex and opex largely overlap with a few exceptions.[57] As an example, these are the factors the AER must take into account when determining whether it is satisfied that a proposed opex forecast for distribution reasonably reflects the expenditure objectives:

(1) the information included in or accompanying the building block proposal

(2) submissions received in the course of consulting on the building block proposal

(3) analysis undertaken by or for the AER and published before the distribution determination is made in its final form

(4) benchmark opex that would be incurred by an efficient Distribution Network Service Provider over the regulatory control period

(5) the actual and expected opex of the Distribution Network Service Provider during any preceding regulatory control periods

(6) the relative prices of operating and capital inputs

(7) the substitution possibilities between operating and capex

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[55] Essential Services Commission, *Electricity Distribution Price Determination 2006–10, Volume 1*, p. 265.

[56] NER, cll 6.5.6(c), 6.5.7(c), 6A.6.6(c) and 6A.6.7(c).

[57] NER, cll 6.5.6(e), 6.5.7(e), 6A.6.6(e) and 6A.6.7(e).

(8) whether the total labour costs included in the capex and opex forecasts for the regulatory control period are consistent with the incentives provided by the applicable service target performance incentive scheme in respect of the regulatory control period

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

(10) the extent the Distribution Network Service Provider has considered, and made provision for, efficient non-network alternatives.

6.3.2 Nature and scope of issues with the current rules

Expenditure objectives

While the AER has not proposed any rule changes with respect to the expenditure objectives, there is a potential issue with the reference to expenditure required to 'maintain' quality, reliability and security of supply.

In June 2011, the MCE agreed to direct the AEMC to review the electricity distribution reliability standards.[58] If the AEMC review leads to lower reliability standards in some jurisdictions then it would seem apparent that a policy expectation is that future capex forecasts would be set lower than they otherwise would be to reflect these lower reliability standards. In this event, there may be a conflict between objectives that require consideration of expenditure to both 'maintain' reliability standards and to 'comply' with the revised (lower) reliability standard.

Rather than pursuing this issue through this rule change proposal, the AER considers this matter is best considered through the AEMC's impending review of distribution reliability standards—given the close connection between the level at which these standards are mandated and how capex forecasts are set under the NER.

Expenditure criteria

The expenditure criteria are no longer required under the proposed construction of the decision making test for setting forecasts of required expenditure. The first criteria is built into the new wording of the decision making test that requires the determination of a forecast of expenditure required to meet the expenditure objectives. In addition, the AER proposes to classify the expenditure criteria relating to demand forecasts and the cost of inputs as an expenditure factor.

Further, it is proposed to delete the criteria relating to the circumstances of the relevant NSP. Good benchmarking practice requires that the characteristics of the individual network be taken into account in the normalisation of the data, including matters such as network topography. However, this is different to taking into account the circumstances of the individual owner of the network. The imprecise language used in the current rules may limit the AER's ability to apply comparative analysis and benchmarking in identifying efficient costs.

58 Energy and Resources Ministers' Meeting Communiqué Perth, 10 June 2011.

Expenditure factors

Process factors

The first three expenditure factors list matters that are procedural in nature and do not substantively add to an assessment against the expenditure criteria. In practice, these expenditure factors create ambiguity as to whether specific weight must be given and how that is to be balanced with the other factors.

Expenditure factor three requires that the AER only consider its own analysis if it is published prior to the making of the final decision. This has the potential to make decision making processes unworkable within the prescribed timeframes. It creates a cycle of publishing analysis that would then prompt a submission which in turn requires further analysis and so forth. This would create opportunities for gaming and delay.

Clarification of factors

The AER understands that the list of expenditure factors is currently not exhaustive. However, to avoid the potential for the any doubt on this issue, it is proposed that it be clarified that the expenditure factors are not exhaustive and that the AER may consider any other factor it considers relevant.

Similarly, it is understood that the factor that requires NSPs to 'make provision for' non-network alternatives refers to the extent to which non-network alternatives have replaced capex in the proposed forecast. However, this could be more clearly stated.

In addition, expenditure factor eight specifically refers to the labour costs included in expenditure forecast and the service target performance incentive scheme (STPIS). While recognising the need for a factor that refers to consistency between expenditure forecasts and applicable incentive schemes, the AER considers the level of specificity in this factor is unwarranted. This level of specificity removes the flexibility of the regulator to consider all expenditure including labour cost levels (past and forecast) relative to service standard targets and or other incentive schemes.

Finally, the AER is also proposing the introduction of a contingent project framework for DNSPs as part of an overall package to efficiently deal with uncertainty. To incorporate the contingent project framework in the distribution rules an additional expenditure factor is required so that the AER can consider whether an element of the capex forecast may be more appropriate as a contingent project.

6.3.3 Proposed rules

Expenditure objectives

The AER supports the retention of a clear and consistent set of expenditure objectives in the NER. Accordingly, no change is proposed to the expenditure objectives at this stage. However, pending the outcome of the review of reliability standards, a change may be required to the objectives to manage cases where reliability standards are reduced.

Expenditure criteria

As outlined in section 0, the AER is proposing to change the decision making test such that it is required to determine the required expenditure that it considers would meet the efficient costs a NSP would require to achieve the expenditure objectives. Under this construction, the expenditure criteria are no longer required.

However, as discussed below, the AER proposes to relocate the criteria that refers to a realistic expectation of the demand forecast and cost inputs to the expenditure factors.

Expenditure factors

It is proposed that the first three expenditure factors that refer to sources of evidence be moved to Part E of the rules. Pursuant to Part E, the AER will still be required to:

- consider any written submissions
- consider the regulatory proposal or revised proposal
- have regard to analysis undertaken by or for the AER.

In addition, the AER proposes the following minor clarification or consequential changes:

- addition of factor that refers to ‘a realistic expectation of the demand forecast and cost inputs’, following the deletion of the expenditure criteria
- clarifies the factor that requires consideration of the extent that the NSP has ‘considered and made provision for non-network solutions’ means the extent to which prudent non-network alternatives can displace parts of the required capex
- adds an opex factor that recognises that the adoption of non-network alternatives can affect opex forecasts
- for the avoidance of doubt, clarifies that the specified expenditure factors are not exhaustive and explicitly allows the consideration of any other relevant factor
- broadens the factor that ensures that forecasts for labour costs are consistent with the service target performance incentive scheme, to ensure that all forecasts are consistent with all the incentive schemes
- includes a new factor required to accommodate the inclusion of a contingent projects mechanism in relation to distribution. [59]

[59] NER, cll 6A.6.6(e)(10) and 6A.6.7(e)(10): Chapter 6A already contains an opex and capex factor that refer to contingent projects.

Table 6.3 Summary of proposed rule change: capital and operating expenditure factors

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.2] [6.9] [6A.2] [6A.9]	6.5.6(e) 6.5.7(e) 6A.6.6(e) 6A.6.7(e)	6.5.6(d) 6.5.7(d) 6A.6.6(d) 6A.6.7(d)	Revision to the chapeau to the opex and capex factors.
[6.3] [6.10] [6A.3] [6A.10]	6.5.6(e)(1)–(3) 6.5.7(e)(1)–(3) 6A.6.6(e)(1)–(3) 6A.6.7(e)(1)–(3)	6.10.1(a)–(c) 6.11.1(a), (b), (d) 6A.12.1(a) 6A.13.1(a)	Revision to: – relocate procedural opex and capex factors; and – remove requirement that analysis undertaken by or for the AER be published prior to the AER's decision.
[6.4] [6.11] [6A.4] [6A.11]	6.5.6(e)(8) 6.5.7(e)(8) 6A.6.6(e)(8) 6A.6.7(e)(8)	6.5.6(d)(5) 6.5.7(d)(5) 6A.6.6(d)(5) 6A.6.7(d)(5)	Revision to opex and capex factors to provide for the AER to consider whether the opex forecast is consistent with the incentives provided in each incentive scheme provided for under chapters 6 and 6A.
[6.5] [6.12] [6A.5] [6A.12]	6.5.6(c)(10) 6.5.7(c)(10) 6A.6.6(e)(12) 6A.6.7(e)(12)	6.5.6(c)(7) 6.5.7(c)(7) 6A.6.6(e)(9) 6A.6.7(d)(9)	Revision to opex and capex factors to provide for the AER to consider any efficient and prudent non network alternatives may impact the opex forecast or displace the opex forecast.
[6.6] [6.13] [6A.6] [6A.13]	–	6.5.6(d)(8) 6.5.7(d)(8) 6A.6.6(d)(11) 6A.6.7(d)(11)	New opex and capex factors to provide that the AER may have regard to a realistic expectation of the demand forecast and cost inputs.
[6.7] [6.14] [6A.7] [6A.14]	–	6.5.6(d)(10) 6.5.7(d)(10) 6A.6.6(d)(12) 6A.6.7(d)(12)	New opex and capex factors to provide for the AER to have regard to any factor it considers relevant.
[10.2] [10.4]	See Part C, Table 3.1	See Part C, Table 3.1	Revisions to the definitions of opex and capex factors.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.1 and 2.1 in Part C. Consequential revisions to the relevant definitions in Chapter 10 are set out at Table 3.1 in Part C.

6.3.4 How the proposed rules address the identified issues

Expenditure criteria

The deletion of the expenditure criteria is largely a consequential amendment following changes to the 'must accept if satisfied' test. However, one of the criteria deleted refers to the 'circumstances of the relevant distribution or transmission network service provider.' Its deletion removes the possible tension between applying comparative analysis and benchmarking in identifying efficient costs while having to take into account the individual circumstances of the service provider. Clearly, the circumstances and characteristics of a NSP is a factor that will be considered by the AER in undertaking comparative or benchmarking analysis. However, this proposal leaves this as a matter for AER's exercise of regulatory judgement.

Expenditure factors

Moving procedural expenditure factors one, two and three to Part E of the NER will remove the ambiguity created by co-locating procedural and substantive matters together in the expenditure factors. This will also allow for the separation of the underlying analysis, supporting information and relevant material that shed light on the key drivers of the expenditure criteria contained in proposals and submissions. These matters can then be taken account of consistent with the relevant factors.

This relocation still requires the AER to consider these matters as part of its overall decision making requirements. Further, the AER is bound by administrative law and procedural fairness. The relocated factor three will not require the AER to publish its analysis (or that which is undertaken for it) prior to the final decision before such analysis can be taken into account. This will remove the condition in the current rules that potentially make the decision making process unworkable. The relevant analysis will also be available as part of the reasons for the AER decisions.[60]

The various clarifications proposed to the expenditure factors ensure that their intent and meaning is clear to all stakeholders and minimises the potential for legal disputes.

6.4 Capex incentives

A key driver of NSPs' investment decisions is the incentives that are established in the regulatory framework. Under certain circumstances, the current regulatory framework creates incentives for network businesses to incur greater than efficient levels of capex. The AER proposes a number of changes that are intended to resolve this problem. In particular, the AER proposes to amend the mechanism used to roll forward the regulatory asset base (RAB).

The strength and effectiveness of an incentive framework depends on the extent to which firms are guaranteed the recovery of their actual costs or the extent to which firms can make financial gains or losses as a result of their actions. There are a number of matters which together form the capex incentive framework. These matters include:

- whether the RAB is periodically re-optimised or rolled forward between regulatory periods. If rolled forward, whether it is rolled forward based on:
  - actual or forecast capex (or some variant of actual or forecast capex)
  - actual or forecast depreciation
- how the capex forecast is determined, and whether there are any adjustments to the capex forecast during the regulatory period (e.g. contingent projects, pass throughs)

60 NER, cll 6.12.2 and 6A.14.2.

- whether any other adjustments are made to the building blocks where forecast and actual capex differ (e.g. an Efficiency Benefit Sharing Scheme (EBSS) applied to capex)

- whether the regulatory WACC (and other payments received by the owner) are higher, lower or equal to the true required return of the service provider.

The RAB is a key component of the building block framework. The current arrangements have the potential to lead to significant increases in RAB without any mechanism to ensure that these increases are efficient.

The AER is concerned that the current RAB roll forward mechanism may not, in some circumstances, sufficiently discipline capex in excess of the original forecast.

6.4.1 Current rules

The NER currently require that the RAB must be adjusted to include all capex incurred during the previous regulatory period.[61] NSPs are not required to restrict expenditure in order to remain within the capex forecast set at the previous determination. There is no ex post review of capex.

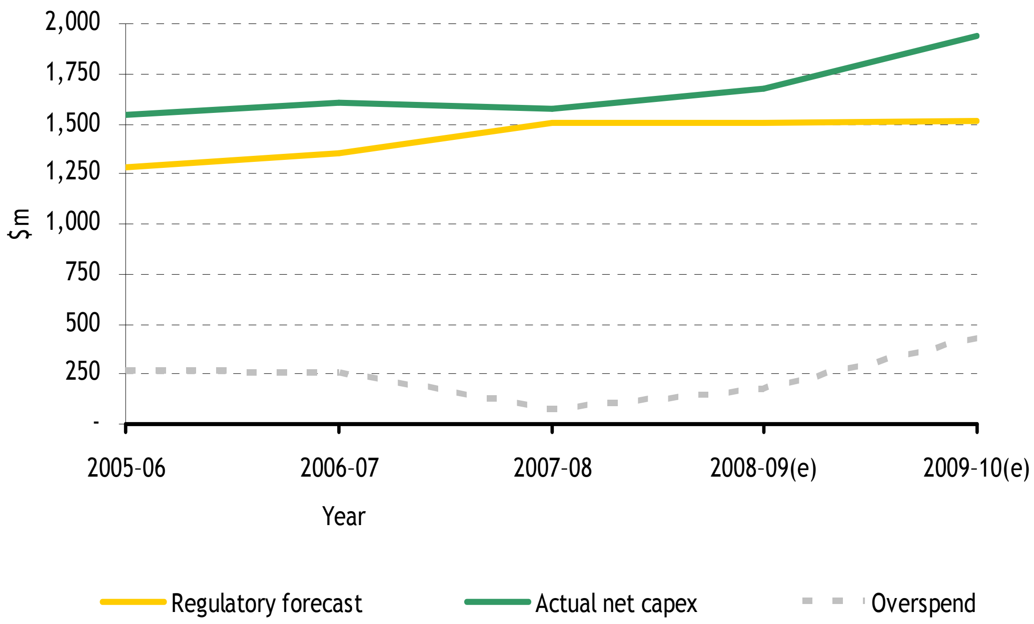
6.4.2 Nature and scope of issues with current rules

The current rules may not provide sufficiently strong incentives to ensure that only efficient investment occurs. This is particularly an issue where the regulated cost of capital (or rate of return) is higher than the actual cost of capital for the NSP, or where the NSP is responding to a broader range of incentives, rather than just financial incentives.

The AER estimates that up to 25 per cent of increases in distribution network charges arising in NSW and Queensland during the most recent round of regulatory resets were attributable to capex in excess of forecasts in the previous period. Figure 6.1 shows the difference between forecast and actual for Queensland DNSPs during the 2005–10 regulatory control period. The equivalent Figure 1.3 in Part A of this document shows the significant capex overspends incurred by NSW DNSPs.

[61] NER, cll S6.2.1(e)(1) and S6A.2.1(f)(1).

Figure 6.1 Combined Qld DNSPs actual and determined capex forecast ($m, 2009-10)



Source: AER Queensland Draft Distribution Determination, 2010-11 to 2014-15, November 2009, pg 85

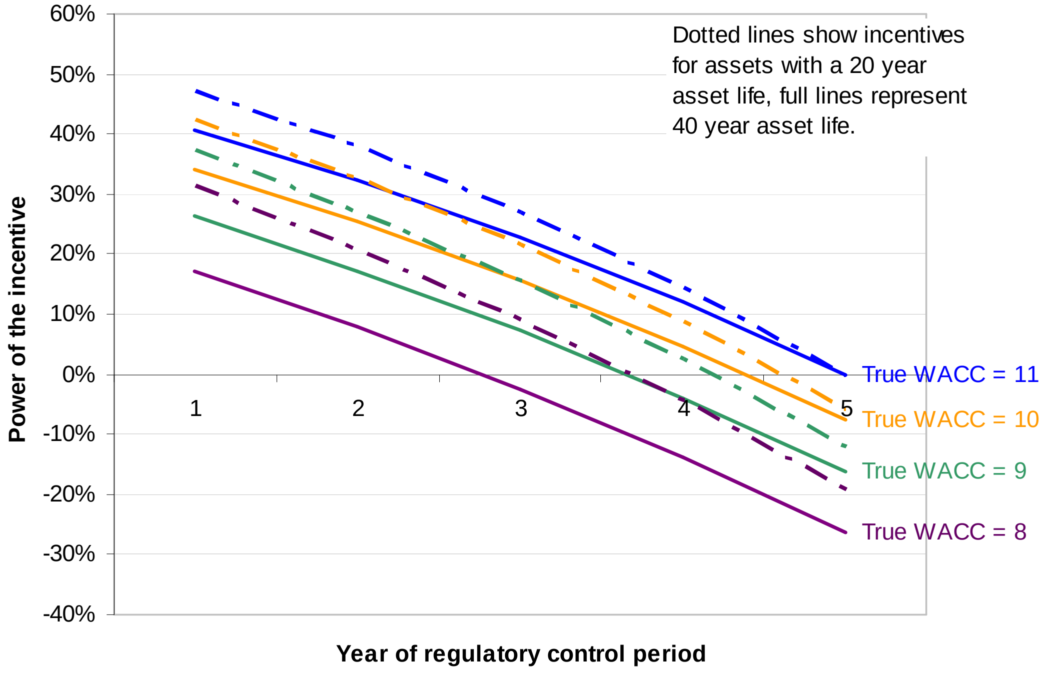
The incentives that apply to NSPs with respect to their capex are complex depend on various elements of the regulatory framework. The current RAB roll forward mechanism creates incentives for network service providers to incur more than efficient levels of capex in some circumstances, particularly in the latter stages of the control period.

Figure 6.2 shows how the strength of incentives on NSPs varies with different WACC outcomes and asset lives under the current RAB roll forward mechanism. It shows how the current approach provides the correct incentives only where the regulatory WACC and the NSP's true WACC are the same. In cases where the true WACC is lower than the regulated WACC there is an incentive to overspend. The chart also shows how the cost to the NSP associated with a capex overspend varies over the course of the regulatory period. Capex overspends arising at the beginning of the control period incur greater costs, because there is a longer delay before the expenditure is rolled into the RAB. During the interim, the network operator must bear depreciation and financing costs.

Figure 6.2 assumes that regulated WACC is 11 per cent. If the true cost of capital is equal to the regulated WACC, then the incentive strengths shown in blue would prevail. In this case, the network business would bear around 40 per cent of the cost of any overspend incurred during year 1 of the regulatory control period. Customers would bear the cost of any overspend incurred during year 5 of the regulatory period.[62]

[62] This analysis assumes a 40 year asset life.

Figure 6.2 Strength of incentives under different WACC outcomes[63]



In the event that the true cost of capital is less than the regulated WACC, the current RAB roll forward mechanism rewards network businesses for overspending their capex forecasts during the latter stages of the regulatory control period. For instance, with a true cost of capital of 8 per cent and a 40 year asset life, a network business that overspends during the fifth year of the control period would receive payments equal to 26 per cent more than the initial cost of the asset over the remaining life of the asset.

Clearly there are many factors beyond those depicted in Figure 6.2 which influence the decisions of NSP. In particular, changes in the reliability standards (determined by state governments) have affected some NSPs' capex programs.

The AER considers that the underlying theoretical incentive properties of the current framework, combined with actual outcomes, make a strong case in favour of strengthening the incentives on NSPs to incur only efficient capex.

6.4.3 Proposed rules

The proposed rules amend the RAB roll forward mechanism such that only capex up to the forecast would be automatically added to the RAB. Any expenditure in excess of the forecast would be subject to a 40/60 sharing factor. Under this approach, 40 per cent of capex in excess of forecast would be funded by shareholders and the remaining 60 per cent would be borne by customers via an adjustment to the RAB at the time of the next network determination. Box 6.2 provides an example of how the capex overspend sharing mechanism would operate.

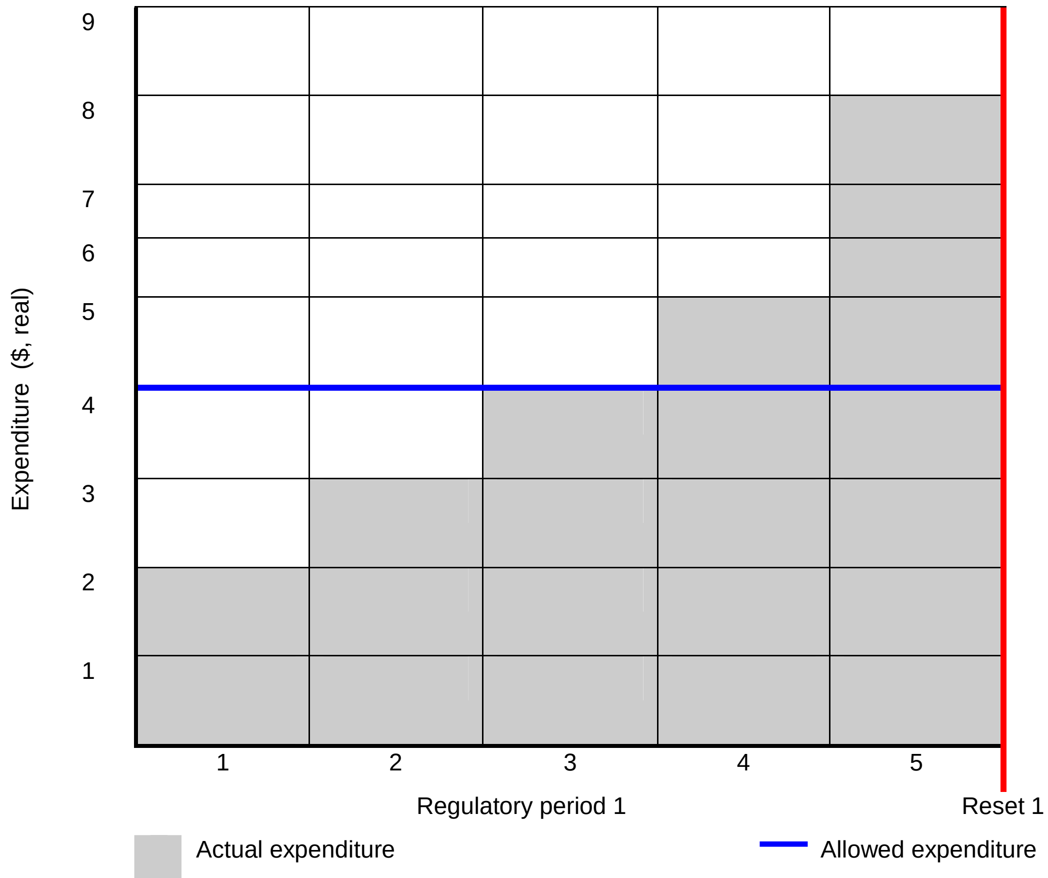
[63] Assumes a regulated WACC of 11 per cent and use of actual depreciation.

Box 6.2—Capex overspend sharing mechanism

Assume that a NSP incurs capex in accordance with diagram below. The NSP underspends by a total of \$3 in years 1 and 2 of the regulatory period and overspends by \$5 in years four and five of the regulatory period. On balance, the NSP has overspent by \$2 over the course of the regulatory period.

In this case, at Reset 1 the AER would adjust the RAB to include the entire allowed capex as determined at the previous reset, plus 60 per cent of the capex overspend: \$20 + \$1.20 = \$21.20.

Example of capex relative to forecast



As occurs at present, actual capex data would not be available for the final year of the regulatory control period at the time of the regulatory reset. Consistent with the current framework, it would be necessary to apply the sharing factor using estimates for 5th year capex. At the time of the next reset, the AER would make an adjustment to account for any differences between estimated and actual expenditure.

When assessing the amount of actual capex incurred by the NSP relative to total forecast capex, the AER would amend the total forecast capex to include any adjustments made during the preceding regulatory period (for instance pursuant to the contingent projects or reopener provisions).

Table 6.4 Summary of proposed rule change: regulatory asset base roll forward incentive mechanism

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.15] [6A.15]	S6.2.1(e)(1) S6A.2.1(f)(1)	S6.2.1(e)(1) S6A.2.1(f)(1)	Revision to: – provide that only actual capex (and where actual capex is not available, estimated capex) up to the amount of the forecast capex allowance determined in the revenue or distribution determination for the relevant regulatory control period adjusted to include (or remove) the amount of any capital expenditure used to determine any approved pass through amounts or negative pass through amounts; and – provide that 60% of any actual capex that exceeds the forecast capex allowance, is to be rolled into the regulatory asset base.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.2 and 2.2 in Part C.

6.4.4 How the proposed rules address the identified issues

The proposed rules strengthen the capex incentive framework. Under the AER's proposal, NSPs would have a strong incentive to avoid overspends since they would fund at least 40 per cent of any capex overspend.

The 40/60 sharing factor has been calculated after considering a range of other models, including a capex rolling incentive. The capex rolling incentive is a well established model which has been used by a number of other regulators including Ofgem, Ofwat and the Office of the Regulator General (now the Victorian Essential Services Commission).[64] The proposed sharing factor of 40 per cent reflects the outcomes associated with capex rolling incentive assuming a weighted average asset life of 40 years, a regulated WACC of 11 per cent and a true WACC of 11 per cent.

In addition, NSPs would continue to bear the financing costs during the remainder of the regulatory period from the time of the overspend. Depending on the depreciation framework adopted (see section 6.5), there may also be a loss of depreciation.

[64] See, for instance:

- Ofgem, *Distribution Price Control Review Final Proposals 265/04*, November 2004.
- Victorian Office of the Regulator General, *Electricity Distribution Price Determination 2001–2005, Volume 1, Statement of Purpose and Reasons*, September 2000.
- Ofwat, *Final determinations for the review of water and sewerage charges 2005–2010*, December 2004.

A sharing mechanism has a number of advantages over a capex rolling incentive. It is a relatively simple mechanism, which clearly signals to NSPs the consequences of an overspend. In addition, the penalty associated with an overspend occurs sooner than would be the case if a five year lag was applied. While a five year capex rolling incentive has strong theoretical incentive properties, Ofgem experienced a number of practical difficulties (see Box 6.3). Accordingly, the AER has decided to propose a simple sharing mechanism.

The approach outlined above assumes that NSP will respond to financial incentives. Some stakeholders have suggested that NSPs respond to a broader range of incentives and other mechanisms may be more effective in promoting capex efficiency.

Box 6.3—Ofgem's experience using a five year capex rolling incentive

Under Ofgem's capex rolling incentive, electricity networks were required to bear financing costs and depreciation for five years before the overspend was rolled into the RAB. Electricity networks also retained the benefit of any underspend for five years before it was deducted from the RAB. This approach created constant incentives over the course of the regulatory period.

However, Ofgem found that in practice the capex rolling incentive had an unexpectedly weak impact on the behaviour of electricity networks. This was because the costs associated with an overspend were unclear, since the strength of the incentives vary depending on other elements of the regulatory framework. Further, many management teams ignored the rolling incentive mechanism since it operated beyond their relevant time horizon.

In response, Ofgem reduced the time lag to two years and introduced symmetrical sharing factors. The sharing factors define the proportion any overspend or underspend to be borne by UK electricity networks, calculated on a net present value basis.

Alternative approach – ex post capex review

The AER has considered a number of alternative methods for strengthening incentives on network service providers to incur only efficient capex. In addition to sharing mechanisms and capex rolling incentives, the AER carefully considered whether to recommend the use of ex post capex reviews.

Under an ex post capex review approach, each NSP's investment program is subject to regulatory scrutiny at the time of the next regulatory review. Only efficient and prudent expenditure is rolled into the RAB. This approach is in widespread use overseas and in the National Electricity Market prior to the 2006 reforms.

In theory, an ex post incentive framework has the potential to create incentives to incur only efficient expenditure while also giving NSPs flexibility to exceed their forecasts if it is efficient to do so.

However, the AER is concerned that by requiring an assessment of the efficiency of investment decisions after they have been made, ex post reviews may add to regulatory risk by creating potential for investment write downs. In addition, the evidentiary burden that the regulator must satisfy before it could disallow an investment is so high that ex post reviews may offer limited protection against inefficient expenditure.

Given this background, the AER considers that a sharing mechanism generates more effective incentives to invest efficiently with less impact on regulatory risk.

In the absence of ex post reviews, it is especially important that the ex ante framework creates incentives on NSPs to incur only efficient capex. In addition, it is important that NSPs are fully compliant with the planning and consultation processes contained in chapter 5 of the NER. Currently, if a project is undertaken by a NSP the actual capex associated with the project is rolled into the RAB, even if the planning and consultation processes were non-compliant.

In the case of a breach of the planning and consultation requirements (such as the RIT-T provisions) it may be appropriate to adopt ex post reviews as a compliance tool available to the AER. This issue was raised in the Report of the Prime Minister's Task Group on Energy Efficiency.65 However, as this issue relates more to the compliance framework for chapter 5 of the NER, it may be more appropriately addressed through the Transmission Frameworks Review.

6.5 Use of actual or forecast depreciation

This rule change proposal ensures that the AER has the flexibility to adopt either a high powered or a lower powered depreciation incentive for TNSPs to achieve a balanced capex incentive framework, consistent with the approach currently allowed for DNSPs under chapter 6 of the NER.

The use of actual or forecast depreciation relates to whether the return of capital forms part of the capex incentive framework. If actual depreciation is used, depreciation is recalculated based on actual capex outcomes. Forecast depreciation applies the value of depreciation that was forecast in the regulatory determination for the relevant regulatory control period.

For example, in the case of a capex overspend, under an actual depreciation framework, the opening RAB would be reduced by a higher amount of depreciation (reflecting the higher capex) than if forecast depreciation was applied. In this case, the NSP loses the return on the capital in excess of the forecast capex and incurs faster depreciation of its RAB. The situation is reversed for capex underspends where the reward is potentially higher. Where forecast depreciation is used, the amount of depreciation included in the RAB roll-forward does not vary with actual capex outcomes during the period. In this case, the calculation of depreciation does not add to the strength of the capex incentive framework.

[65] Report of the Prime Minister's Task Group on Energy Efficiency, July 2010, pp. 167–170.

6.5.1 Current rules

Chapter 6A of the NER requires the AER to use actual depreciation for TNSPs.[66] Chapter 6 of the NER allows the AER to use either forecast or actual depreciation for DNSPs.[67]

6.5.2 Nature and scope of issues with the current rules

The current capex incentive framework relies predominantly on the use of actual depreciation to strengthen what is otherwise a very low powered capex incentive framework. That is, the incentive to achieve efficiencies in capex declines over the regulatory control period.[68]

An important consideration in the choice between the use of actual or forecast depreciation is whether any differences between the actual and forecast outcomes are likely to be driven by permanent efficiency improvements or whether they reflect uncontrollable factors or the temporary deferral of investments. If the differences are likely to result from uncontrollable factors, the temporary deferral of investments or the systematic over-forecasting of capex, then the use of actual depreciation will result in higher windfall gains/losses than if forecast depreciation is adopted.

The AEMC considered that a relatively low powered capex incentive paired with a higher powered opex incentive may distort TNSPs use of inputs, thereby creating productive inefficiencies. In contrast, MCE determined it was appropriate for the AER to have the discretion in relation to distribution determinations to adopt either forecast or actual depreciation.[69]

6.5.3 Proposed rules

This proposal would amend the roll-forward provisions in chapter 6A to allow the regulator to adopt either forecast or actual depreciation for TNSPs.

Table 6.5 Summary of proposed rule change: actual or forecast depreciation

No.	Current rule(s)	Proposed rule(s)	Remarks
[6A.30]	S6A.2.1(f)(5) 6A.6.3(b)(3)	S6A.2.1(f)(5) 6A.6.3(b)(3)	Revision to remove the reference to actual depreciation.

Note: This table is a summary, the complete set of proposed rule changes are set out at Table 2.8 in Part C.

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66 NER, cl S6A.2.1(f)(5).

67 NER, cl 6.12.1(18), though in practice for electricity the AER has consistently adopted actual depreciation to date.

68 This is because, under the building block approach to regulation, an NSP that is able to reduce expenditure near the beginning of the regulatory control period is able to retain the benefits of the reduction longer than if it were to reduce expenditure closer to the end of the regulatory control period.

69 MCE SCO, *SCO response to stakeholder comments on the exposure draft of the NER for distribution revenue and pricing (chapter 6)*, 2007. p. 15.

6.5.4 How the proposed rules address the identified issues

The framework would have the flexibility to adopt either actual or forecast depreciation for TNSPs where appropriate. For example, when a significant proportion of the forecast capex reflects uncontrollable factors, forecast depreciation could apply, reducing the prospect of windfall gains and losses. This would ensure that the TNSP is not rewarded for cost reductions which do not reflect cost efficiencies, or unduly penalised for circumstances outside its control.

6.6 Contingent projects, capex reopeners and pass through events

The above sections have outlined proposed changes to the manner in which forecasts of required expenditure are set, together with changes to the capex incentive framework. The AER recognises that these changes are closely linked and that together the changes have the potential to negatively impact NSPs in the event of a significant event or unforeseen circumstances.

Accordingly, as part of this package of measures the AER is also proposing a comprehensive framework for managing uncertainty, by introducing both contingent projects and a re-opener provision for DNSPs. The current framework attempts to deal with the risk of under and over forecasting by limiting regulatory discretion. As has been shown, this results in systemically inflated forecasts. In preference, the AER proposes a less restrictive framework for setting forecasts, together with purpose built provisions to deal with uncertainty and unforeseen events.

This approach ensures that NSPs are afforded a reasonable opportunity to recover at least the efficient costs of their operation, while advancing the long term interests of electricity consumers by removing the systemic upward bias in forecasts.

6.6.1 Current rules

Under the current rules, adjustments within a regulatory control period to TNSPs' maximum allowed revenues (MAR) are permitted for cost pass through events, contingent projects and capex reopeners.[70] For DNSPs adjustments are limited to pass through events.

The contingent projects and capex reopener frameworks are asymmetric in that the approval of a project or reopener during the regulatory period can only lead to an increase in a TNSP's MAR. The pass through framework is symmetric and may lead to an increase (positive pass through event) or decrease (negative pass through event) in a NSP's regulated revenue.

Additionally, pass through events may be associated with changes in opex, capex or both. Contingent projects and capex reopeners relate to capex and any incremental opex associated with that capex.

[70] Chapter 6A also contains an adjustment mechanism for network support pass through events: NER, cl 6A.7.2.

Contingent projects (chapter 6A only)

The contingent projects framework is for large identified capital projects that are sufficiently uncertain, either in respect of timing or cost, that they cannot be included in the capex forecast at the regulatory reset.[71] Among other matters, for each contingent project:

- the costs must not otherwise be provided for (in whole or in part) in the capex forecast
- the costs must exceed $10 million or 5 per cent of the relevant transmission network's MAR in the first year of the regulatory period (whichever is the greater)
- there must be a clearly defined 'trigger', set out in the transmission determination, the occurrence of which makes the contingent project reasonably necessary to achieve the capex objectives.[72]

Capex reopeners (chapter 6A only)

The capex reopener framework is for events which are beyond the reasonable control of the TNSP and, in the absence of the capex reopener, would significantly impact on its financial viability.[73] For the determination to be reopened, the TNSP must suffer an adverse event and among other things:

- the occurrence of that event could not reasonably have been foreseen at the time of the transmission determination
- no capex was included within the capex forecast in relation to the event
- requires capex in excess of 5 per cent of the value of the RAB to rectify
- if rectified is reasonably likely to result in the TNSP exceeding its total capex forecast, and it is not able to reduce capex in other areas without materially adversely affecting reliability and security.[74]

Cost pass throughs events (chapters 6 and 6A)

The pass through framework provides a degree of protection for NSPs from the impact of unexpected changes in costs outside of their control.[75] The NER prescribes a similar but not identical list of pass through events for TNSPs and DNSPs. For TNSPs this list is exhaustive. For DNSPs, the AER may include additional events in the distribution determination.

If an event occurs which materially increases the costs of providing network services, then the NSP may seek permission to increase their maximum allowed revenues to

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71 AEMC, *Rule Determination*, 16 November 2006, pp. 53–60.
72 NER, cl 6A.8.1.
73 AEMC, *Rule Determination*, 16 November 2006, p. 60.
74 NER, cl 6A.7.1.
75 AEMC, *Rule Determination*, 16 November 2006, p. 104.

reflect the additional (efficient) cost.[76] In the case of transmission, the term 'materially' is defined such that the change in costs must exceed one per cent of the transmission network's MAR before it is eligible to be considered as a cost pass through event. For DNSPs, costs must also 'materially' increase or decrease, but this term is not defined.

When a pass through event occurs the costs incurred or saved by the NSP are not necessarily recovered from (or returned to) users during that same regulatory control period.[77] Among other reasons, the AER may determine that the costs should be recovered by or returned to users over time (such as over the economic life of the assets, with respect to capex).

6.6.2 Nature and scope of issues with current rules

Inefficient method of dealing with uncertainty

Currently, the arrangements for dealing with uncertainty rely too heavily on a prescriptive framework for setting forecasts of required expenditure and a presumption in favour of accepting NSPs' proposals. This exposes consumers to the risk of funding revenue partly driven by upwardly biased estimates of efficient cost, rather than relying on a purpose built framework for managing uncertainty.

Contingent project threshold

In setting out its reasons for the contingent project trigger threshold, the AEMC stated:

> By aligning the lower bound to $10 million it has the advantage of being the same amount necessary for the application of the regulatory test to new augmentation investment, while the 5 per cent of the MAR upper bound is more appropriate than the previous 5 per cent of the RAB.[78]

While the AEMC's rationale for the (lower bound) threshold relied on consistency with the regulatory test threshold (now the RIT-T), under the NER the RIT-T threshold is subject to review by the AER every three years.[79] This creates the potential for a disconnect, in contrast to the AEMC's intention, between the threshold above which the RIT-T must be applied and the threshold applicable for contingent projects.

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76 NER, cll 6.6.1 and 6A.7.3. Similarly, if an event occurs which materially decreases the costs of providing network services, then the rules establish a procedure by which the AER may seek to decrease a network service providers' maximum allowed revenues.

77 The NER distinguishes between the 'eligible pass through amount' and the 'approved pass through amount'. The eligible pass through amount is the increase in costs in the provision of network services that the NSP has occurred and is likely to incur as a result of the pass through event until the end of the current regulatory control period. The approved pass through amount is the amount the AER determines (or is taken to have determined) should be passed through to users in the current regulatory control period.

78 AEMC, *Rule Determination*, 16 November 2006, p. 59.

79 NER, cl 5.6.5E.

Pass through events

There are two problems with the current pass through rules. These are:

- unlike chapter 6A, the absence of a defined materiality threshold that applies to cost pass through events in chapter 6 creates uncertainty for stakeholders
- the potential for a ‘double-recovery’ of pass through costs of a capital nature due to a mis-match between the RAB roll forward rules and the pass through rules.

On the materiality threshold issue, the incentive based framework of the five yearly reset model can be undermined by overly frequent cost pass through applications to adjust revenue determinations. If the framework offers too much flexibility to adjust regulatory decisions, then NSPs have an incentive to devote resources to continually seeking upward adjustments to their forecasts rather than to beating their targets.

Accordingly, it is important that the mechanisms for catering for uncertainty are subject to clearly defined triggers and in this case, a defined materiality threshold for cost pass through events in chapter 6.

On the potential double-recovery issue, once a positive change event or a negative change event occurs, the pass through provisions allow the AER to determine the timeframe over which an increase in relevant costs is to be recovered from users. For example, where there are capital costs, the AER could determine to treat the costs like opex, meaning the costs would be recovered in the year they are or are expected to be incurred. At the same time, the RAB roll forward provisions require all capex incurred in a regulatory control period to be included when establishing the opening value of the RAB at the following regulatory control period.

This means that even if the AER permitted (through the pass through rules) the full recovery of capital costs in the regulatory control period in which they are incurred, the actual costs incurred with these assets would still be included in the opening value of the RAB at the following regulatory control period. This means that those costs would be recovered again from users in the following and possibly future regulatory control periods.

6.6.3 Proposed rules

Mechanisms to deal with uncertainty

This rule change proposal extends the current re-opener provision for TNSPs to DNSPs and introduces a contingent project framework for DNSPs. The proposed distribution contingent project framework is similar to the current transmission version, with a trigger threshold of $10 million.

The AER also proposes that the trigger threshold for NSPs be open to amendment by the AER through a guideline.

Table 6.6 Summary of proposed rule change: reopening of distribution determination for capital expenditure

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.16]	–	6.6.4	New clause to provide a distribution determination to be reopened for capital expenditure for an event beyond the reasonable control of a distribution network service provider.

Note: This table is a summary, the complete set of proposed rule changes are set out at Table 1.3 in Part C.

Table 6.7 Summary of proposed rule change: contingent projects

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.18] [6A.16] [6A.17] [6A.18] [6A.19] [6A.20]	6A.8.1 6A.8.2	6.6A.1 6.6A.2 6.6A.3 6A.8.1 6A.8.2 6A.8.3	Revisions to: – provide for the AER to identify any contingent projects in a distribution determination or a transmission determination; – provide for a DNSP or a TNSP to apply during the regulatory control period for the AER to reopen the distribution determination or transmission determination in the event a trigger event for a contingent project occurs; and – provide for the AER to develop and publish the Distribution Contingent Project Guidelines and the Transmission Contingent Project Guidelines to specify the appropriate threshold for the purposes of a contingent project.
[10.5]	See Part C, Table 3.1	See Part C, Table 3.1	Revisions and new definitions relating to contingent projects.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.5 and 2.3 in Part C. Consequential revisions to the relevant definitions in Chapter 10 are set out at Table 3.1.

Cost pass-throughs

It is proposed that a one per cent materiality threshold be prescribed before a DNSP may apply to the AER for an adjustment to their allowed revenues under the cost pass through provisions (consistent with the current transmission framework). In addition, clarifications are proposed to ensure that the cost of any capex pass through is not recovered twice from customers

Table 6.8 Summary of proposed rule change: cost pass throughs

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.26] [6.27] [6A.40]	6.2.8(4) 6.2.8(5) S6.2.1(e)(4) S6A.2.1(f)(4)	6.2.8(4) S6.2.1(e)(4) S6A.2.1(f)(4)	Revision to: – remove the ability for the AER to publish guidelines setting out its likely approach to determining materiality in the context of possible pass through events, consequential to defining material for the purposes of clause 6.6.1; and – to include the effect of the amount of any capex included to determine any approved or required pass through amounts on the total forecast capex and depreciation for the purposes of establishing the opening value of the regulatory asset base: [6.15].
[10.6]	See Part C, Table 3.1	See Part C, Table 3.1	Revision to definitions of materially, positive change event and negative change event.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.10 and 2.14 in Part C. Consequential revisions to the relevant definitions in Chapter 10 are set out at Table 3.1 in Part C.

6.6.4 How the proposed rules address the identified issues

Introduction of capex re-opener and contingent project provisions in distribution

Section 6.4 of this proposal outlined stronger incentives on electricity networks to not overspend their expenditure forecasts. However, the AER recognises that there are occasions where an electricity network may be required to incur efficient expenditure above the amount set in the forecast due to unforeseen events.

In line with the revenue and principle principles, NSPs must be given the opportunity to recover at least efficient costs. Accordingly, if there are legitimate reasons why the expenditure forecasts determined at the previous reset are no longer appropriate, then in certain limited circumstances it is appropriate to re-open the forecasts to reflect the new conditions. The proposed rules allow this to occur, while maintaining appropriate thresholds to ensure that the framework does not becomes a ‘cost of service’ model.

This proposal is a more efficient way of dealing with uncertainty than the current model that relies on a restrictive approach to determining forecasts of required expenditure. It ensures that the uncertainty can be managed, while ensuring consumers are not exposed to the risk of upwardly biased forecasts to accommodate uncertain events.

The contingent projects regime reflects the need to ensure that there is appropriate flexibility for the treatment of uncertain projects in an ex ante regime. Introducing these arrangements to distribution would help to manage uncertainty in the distribution sector, by adding flexibility to DNSPs' allowed revenues without creating a need to reopen the AER's decision.

The AER proposes a threshold of $10 million for contingent projects in distribution. However, as per the proposed transmission rule change, the AER proposes that this threshold be open to amendment through as AER guideline. This will permit the AER to align the threshold for contingent projects with the threshold for RIT-T (and possible RIT-D) investments, consistent with the AEMC's original reasoning.

Pass through events

Materiality threshold

During the development of the chapter 6A rules, GridAustralia (then ETNOF) argued that the one per cent threshold was excessive and recommended that the definition be amended to 'material' amounts. In response, the AEMC stated:

> The Commission considers that the threshold for a pass through is important to ensuring stability and predictability of the revenue cap regime for both the regulator and the regulated businesses. Removing the threshold would lead to greater uncertainty and increase the administrative costs for the AER to determine what constitutes a material event.[80]

The AEMC's views remain valid and are supportive of the codification of a materiality threshold in chapter 6. A one per cent materiality threshold provides an appropriate balance between providing certainty for distribution networks and maintaining incentives on those networks to operate efficiently.

This proposal would also bring the arrangements that apply to DNSPs into line with TNSPs. There are no apparent differences in the underlying nature of transmission and distribution networks that warrant a differing regulatory treatment in respect of the pass through materiality threshold. The proposal would also reduce the administrative burden on DNSPs, the AER and other stakeholders associated with the potential of overly frequent cost pass through applications.

Interaction between pass through rules and RAB roll-forward rules

The proposed changes also ensure consistency between the treatment of capex included in approved pass through amounts and the RAB roll-forward provisions. Specifically, in calculating the amount of depreciation for the purposes of the establishing the opening value of the RAB for the following regulatory control period, the AER will be required to take into account the treatment of capex (if any) that was included in any approved pass through amounts during the regulatory control period. As a result, the proposed rules will remove the potential for double-recovery of this capex that exists under the current rules.

Secondly, under the proposed rules, the same incentive arrangements will apply equally to capex included in approved pass through amounts and actual capex associated with the forecast capex allowance. Specifically, for the purposes of calculating the overspend penalty proposed in section 6.4, an overspend will be the

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[80] AEMC, *Rule Determination*, 16 November 2006, p. 106.

amount of actual capex (if any) that is greater than the forecast capex allowance adjusted accordingly for any additional capex included in the calculation of the approved pass through amount.[81]

6.7 Excluding related party margins and capitalisation changes from the RAB

A NSP may outsource a number of management and operational services to separate companies. For these services, the NSP will pay the contractor an agreed contract price. The actual charge (price) of this contract is then generally included in the forecast of required expenditure by the NSP.

The term 'margin' reflects any difference between a contract charge (price) and a contractor's actual direct costs. These margins may be considered to be capital in nature and therefore meet the requirement of being 'capex incurred during the previous period' for the RAB roll forward.[82]

However, often these contracted companies have common ownership with the NSP, resulting in the ‘margin’ being retained within the one company owner. This may be an efficient arrangement where the costs of the service reflect those obtainable in the competitive market. On the other hand, there are circumstances where these related party margins paid by the NSPs do not reasonably reflect efficient costs and are excluded from the forecast expenditure.

This rule change proposal ensures that, if the AER determines a margin or portion of a margin is found to be inefficient and therefore excluded from forecast expenditure, such margins would be treated on a consistent basis and excluded from the RAB when actual expenditures are accounted for at the end of the regulatory control period. Similarly, this proposal will remove any perverse incentives for NSPs to change their approaches to capitalising overheads during a regulatory control period in order to roll in higher amounts of capitalised overheads into the RAB at the end of the regulatory control period.

6.7.1 Current rules

The NER provides that the previous value of the regulatory asset base must be increased by the amount of all capex incurred during the previous regulatory control period.[83]

6.7.2 Nature and scope of issues with the current rules

There are circumstances where margins paid by the NSPs to their related parties do not reasonably reflect efficient costs and are excluded from the forecast expenditure. However, margins may be considered to be capital in nature and therefore be recognised as 'capex incurred during the previous period' for the purposes of the RAB

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81 Similarly, the forecast capex allowance will be adjusted downwards where the pass through event leads to a reduction in required capex.

82 NER, cll S6A.2.1(f)(1) and S6.2.1(e)(1). Adjustments for stranded assets in limited circumstances are also part of current chapter 6A rules.

83 NER, cll S6A.2.1(f)(1) and S6.2.1(e)(1).

roll forward.[84] The current rule provisions therefore contain a potential inconsistency in how margins are treated, and do not adequately address the incentive for NSPs to seek outcomes contrary to the efficiency objectives of the regulatory framework through related party transactions.

For example, a NSP may characterise the contract charge (price) as capex while the actual costs of service delivery incurred by the related party may be lower due to efficiency gains or relevantly because of an inflated contract charge including profit margins. In this situation, where actual contract charges are rolled into the RAB, these efficiency gains or any inflated charges are retained by the ultimate owner(s) of both entities and there is no mechanism for these gains to be shared with consumers.

In the case of opex forecasts, incentive carryover mechanisms and the setting of forecasts based on expected underlying costs (not simply contracted rates) ensure that efficiency gains are retained by the NSP for an appropriate amount of time then shared with consumers. However, no such sharing mechanism exists in relation to capex.

Similarly, an issue may arise where a forecast for required opex is determined on an ex ante basis, then through changes in capitalisation policies, a NSP may reclassify certain costs as capex incurred for rolling into its RAB. In this way, the NSP would be compensated in its forecast opex and again through depreciation and returns on capital once the amount is recognised as actual capex. In this case, there has been no change in the underlying capital cost of service delivery, hence the NSPs would not be penalised for incurring any foregone returns on actual ‘capex’ above the benchmark.

These issues were recognised during the development of chapters 6 and 6A and the AER was provided the discretion to consider the extent to which costs are not derived through competitive tendering or arm’s length negotiation when assessing proposed capex forecasts.[85] However the AEMC only addressed this issue in respect of the capex forecast and not the actual capex in the RAB roll forward.

The AER has raised concerns about the current rules regarding capitalisation changes and related party profit margins in the RAB roll forward, in its Victorian electricity distribution final decision for 2011–15. The presumption in clause S6.2.1(e)(1) of the NER that the AER will automatically recognise all capex incurred in the previous regulatory control period in the DNSPs' RAB roll forward calculations highlights a potentially serious issue with the capex incentive framework under chapter 6 of the NER.[86]

The Victorian Minister for Energy and Resources also raised concerns regarding the inclusion of related party profit margins in the RAB roll forward during the 2011–15

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84 NER, cll S6A.2.1(f)(1) and S6.2.1(e)(1). Chapter 6A provides for adjustments to be made for stranded assets in limited circumstances.

85 AEMC, *Rule Determination*, 16 November 2006, p. 118.

86 *AER, Final decision Victorian electricity distribution network service providers distribution determination 2011–2015*, 2010, pp. 455–59.

Victorian distribution determination process and the subsequent Tribunal review process.[87]

While this matter is currently the subject of a review before the Tribunal, the AER considers that the current rules should be amended to make it clear that related party profit margins can be excluded from the RAB roll forward. The current rules should also be changed to exclude the effect of changes in capitalisation policies from the RAB roll forward.

6.7.3 Proposed rules

Under the proposed rules, the AER would be able to exclude capex relating to changes in capitalisation policy and related party profit margins from the RAB roll forward at the end of the regulatory control period on the basis that such amounts were not incurred in accordance with their treatment on an ex ante basis.

Table 6.9 Summary of proposed rule change: excluding related party margins and capitalised overheads from the regulatory asset base

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.19] [6A.22]	S6.2.1(e)(1) S6A.2.1(f)(1)	S6.2.1(e)(1) S6A.2.1(f)(1)	New clauses to provide that related party margins or capitalised overheads are only included to the extent that they have been incurred consistently with and as provided for in the total of the forecast capital expenditure decided in the transmission determination or the distribution determination for that previous period.
[10.7]	See Part C, Table 3.1	See Part C, Table 3.1	Revision to include new definitions of related party margins, related party and overheads.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.6 and 2.5 in Part C. New relevant definitions in Chapter 10 are set out at Table 3.1 in Part C.

6.7.4 How the proposed rules address the identified issues

The proposed rules will require the AER to determine amounts of margins and capitalised overheads that, pursuant to the previous transmission or distribution determination, were permitted to be incurred on an ex ante basis. If capitalised related party profit margins had been disallowed in forecast capex under the previous determination, the AER would need to consider whether the NSP's actual capex for the purposes of the roll forward was incurred on a consistent basis, that is, whether it includes any margins deemed to be inefficient.

Similarly, if the amount of capitalised overheads that forms part of actual capex have increased due to a change in capitalisation policy that occurred since the time the forecast capex for a particular regulatory control period was determined, the NSP

[87] Minister for Energy and Resources, *Submission to the AER*, 20 August 2010, pp. 1–4.

would not be able to include those amounts in the RAB at the commencement of the next regulatory control period.

The proposed rules will address any incentives and ability that a NSP may have to roll in the capitalisation change and related party profit margins in the RAB which were disallowed in the capex forecast.

6.8 Other incentive schemes

This proposal allows the introduction of new incentive schemes, subject to any scheme meeting certain principles. These principles will be set out in chapters 6 and 6A of the NER.

6.8.1 Current rules

For TNSPs the current rules require that the AER must apply an efficiency benefit sharing scheme (EBSS) and a service target performance incentive scheme (STPIS).[88] In the case of DNSPs, the AER may apply a STPIS, an EBSS and a demand management incentive scheme (DMIS).[89]

The EBSS provides for a fair sharing between NSPs and network users of the efficiency gains and losses derived from the opex of NSPs for a regulatory control period. The STPIS provides incentives (which may include targets) for NSPs to maintain and improve service performance. The DMIS provides incentives for DNSPs to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.

6.8.2 Nature and scope of issues with the current rules

There are a wide range of incentive schemes operating in other jurisdictions (notably the UK) which are not currently part of chapters 6 or 6A.[90] Regulatory best practice is continually evolving, including the development of innovative incentive schemes. While the AER does not currently endorse any particular new incentive scheme, the current process to implement new schemes is cumbersome.

In order for a new incentive scheme to be applied to NSPs under the current rules, a full rule change process would need to be conducted. This process imposes significant costs on all interested stakeholders. The AER considers that it is an overly costly process to incrementally develop the regulatory regime in order to keep pace with international best practice.

The current schemes have developed incrementally over time. For example, after chapter 6A of the NER was developed, MCE added the DMIS and EBSS for electricity losses when developing chapter 6 of the NER. The AER understands these ideas were not contemplated by the AEMC when chapter 6A of the NER was developed.

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88 NER, cll 6A.6.5(e), 6A.7.4(e), 6A.14.1(1)(iii) and 6A.14.1(1)(iv).
89 NER, cl 6.12.1(9).
90 See for instance, Ofgem (2009), *Electricity Distribution Price Control Review Final Proposals – Incentives and Obligations*, Ref: 145/09, 7 December 2009.

Currently, through the demand side participation review, the AEMC has commenced consultation on a rule change request from the MCE in relation to amending the EBSS framework applicable to TNSPs to require the AER to consider the scheme's effect on the TNSPs' incentive to undertake non-network alternative expenditure.[91] As an additional example, in a submission to the MCE on the Draft National Electricity Rules, the ESCV stated that while a service performance scheme is now a standard and fundamental part of the regulatory framework, such a scheme did not exist when economic regulation of electricity networks began in Australia, and was only added by some jurisdictional regulators over time.[92]

6.8.3 Proposed rules

Under the proposed rules, the AER would be able to develop and publish other incentive schemes beyond the EBSS, STPIS and DMIS, subject to the any such incentive scheme meeting the following principles:

- the benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme
- in developing a new scheme, the AER must have regard to:
  - possible effects of the scheme on incentives for the implementation of non-network alternatives
  - the need to ensure that the incentives are sufficient to offset any financial incentives the NSPs may have to reduce costs at the expense of service levels
  - the willingness of the customer or end user to pay for increases resulting from implementation of the scheme
  - ensuring that financial or non-financial targets and service standards set by the scheme do not put the safe and reliable operation of the electricity transmission or distribution networks at risk.

Amendments have also been proposed to the requirement in chapter 6A of the NER that the AER must develop EBSS and STPIS schemes for TNSPs. Instead, the proposed rules reflect the arrangements that currently apply under chapter 6, where the AER has the option whether or not to apply any given scheme, with the decision to apply or not apply made at the time of the distribution determination.

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91 AEMC, *Rule changes -Efficiency Benefit Sharing Scheme and Demand Management Expenditure by Transmission Businesses*, currently in preparation of draft determination.

92 ESCV, *Essential Services Commission of Victoria Submission on the National Electricity Rules Distribution Revenue and Pricing Rules*, April 2007, pp. 2 and 3.

Table 6.10 Summary of proposed rule change: other incentive schemes

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.20] [6A.29]	–	6.6.6 6A.7.5	New clauses to provide for the AER to develop and publish an incentive scheme or schemes other than the service target performance incentive scheme, demand management incentive scheme and the efficiency benefit sharing scheme where the AER considers that there are benefits to end users or customers arising from the incentive scheme or schemes.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.7 and 2.7 in Part C.

Table 6.11 Summary of proposed rule change: discretion to apply the incentive schemes

No.	Current rule(s)	Proposed rule(s)	Remarks
[6A.34]	6A.4.2(a)(5), (6) S6A.1.3(2), (3)	6A.4.2(a)(5), (6) S6A.1.3(2), (3)	Revisions to include reference to the ‘applicable’ service target performance incentive scheme and efficiency benefit sharing scheme.

Note: This table is a summary, the complete set of proposed rule changes are set out at Table 2.10 in Part C.

6.8.4 How the proposed rules address the identified issues

Incentive schemes are an important part of the regulatory toolkit and the framework should be sufficiently flexible to respond to developments in regulatory best practice.

The proposed rules allow for additions to the regulatory regime thereby avoiding the need for a rule change each time a development in regulatory best practice arises.

6.9 Treatment of shared assets

In addition to the other incentive schemes discussed above, the AER considers that the current rules should recognise that some of the assets owned and utilised by NSPs to provide electricity services are also used in the provision of services other than standard control services. Users who effectively pay for the standard control assets currently receive no compensation for use of these assets to deliver other services.

Regulators have required such compensations in the past, as the examples below demonstrate. However, the NER do not currently allow such compensation. This means that users who were previously sharing in the benefits under the state based regulatory arrangements, are no longer doing so. The potential for regulatory assets to be used for other purposes is also arguably growing, with the use of regulatory assets in facilitating the provision of broadband services being one such example.

6.9.1 Current rules

The current rules do not allow the AER to make a revenue adjustment for the use of standard control assets in the provision of other services, including unregulated services. This results in standard control service customers paying for 100 per cent of the costs of an asset, but receiving no compensation when the same asset is used by the service provider in undertaking other activities.

An exception is in Queensland where a mechanism developed by the QCA was preserved under the transitional provisions in the NER. These transitional provisions for Queensland expire at the end of the current regulatory period in 2015.[93]

6.9.2 Nature and scope of issues with the current rules

The current rules make no provision for consumers to receive compensation for shared assets that are used to earn unregulated revenue. This means that consumers that used to benefit under state based regulatory arrangements are no longer able to receive any compensation.

For example, ESCOSA developed a profit sharing factor where 40 per cent of pre-tax annual profit earned from non-prescribed services which are based on access to prescribed assets were treated as prescribed revenue.[94] This adjustment was applied annually. The last sharing factor adjustment was to 2010-11 regulated prices when $2.2 million (40 per cent) of the $5.5 million profits from unregulated activities using regulated assets was shared with users.[95] Forecast revenue adjustments for the use of shared assets for non-standard control services are included in the building blocks assessments for the Queensland distribution networks. In addition, an under/over recovery adjustment is included in Ergon Energy's control formula for any difference between the forecast and actual use of these shared assets for non-standard control services.[96]

The use of existing poles and pits to provide access for NBN services will be a national issue. While the activities may be covered by the existing approach to the use of shared assets in Queensland, DNSPs in other jurisdictions are not required to share any additional revenues they earn from facilitating NBN services through the use of shared assets.

6.9.3 Proposed rules

The proposed rules will allow the AER to include a revenue adjustment or mechanism for situations where shared assets are used for non-standard control services, including unregulated services.

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93 See clause 11.16.2 of the NER and the definition of 'regulatory control period' in clause 11.16.1 of the NER.

94 ETSA Utilities has HFC cables for Telstra/Optus cable TV strung along its electricity poles.

95 Appendix E to ETSA Utilities 2010-11 pricing proposal.

96 No such unders/overs adjustment applies to Energex.

The proposed rules would recognise that; where assets forming part of the regulatory asset base for standard control services are used or could be used in the provision of services other than standard control services, the AER may add an adjustment or mechanism to the distribution determination to compensate standard control services customers for the use or potential use of these assets.

Chapter 6A could also include a similar rule to the one for standard control services. However, the AER considers the use of regulated assets to provide unregulated activities is less common for transmission networks than it is for distribution networks. Accordingly, no new rule is proposed in respect of transmission.

Table 6.12 Summary of proposed rule change: treatment of shared assets

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.21]	–	6.4.3(a)(8) 6.8.1(b)(2) 6.12.1(13A)	Revisions to: – introduce new clause to allow for any revenue decrement for that year arising from; – introduce new clause to provide for the AER to set out in the framework and approach paper its likely approach to; and – to require the AER to make a constituent decision in relation to, the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than the provision of standard control services.

Note: This table is a summary, the complete set of proposed rule changes are set out at Table 1.8 in Part C.

6.9.4 How the proposed rules address the identified issues

The proposed rules address the issue by making it clear that the AER can make a revenue adjustment to the building blocks that allows users to benefit if the assets they have funded are used to provide other services.

Revenue adjustments would be preferable where reasonable forecasts of use can be made. In such circumstances, smoother prices could be obtained by including an ex-ante revenue adjustment in the building blocks calculation.[97] A control mechanism adjustment (for example, a profit share mechanism) would be preferable where the benefits derived from, and use of, the shared assets for other purposes involves significant uncertainty and therefore forecasting a reasonable revenue adjustment is

97 A revenue adjustment could include an unders and overs adjustment for any difference between forecast and actual use of assets. Such an unders and overs adjustment would need to be included in the control formula.

problematic (if not impossible). In such circumstances the AER would seek to set the incentives on an ex ante basis (for example, the AER could state that a certain proportion of pre-tax profits from these other activities should be shared with users) but would only make the revenue adjustment ex post, such as during the annual price approval process.

Given that the AER can not anticipate which circumstances it may face, it would be desirable that the AER have the ability to adopt the most appropriate approach based on the circumstances it encounters. For similar data availability reasons, the decision on the specific approach to be taken can not always be confirmed at the framework and approach stage. Accordingly, the intention is for the AER to signal its likely approach at this stage, but to finalise the approach during the determination stage.

In developing chapter 6A, the AEMC indicated that it understood that no assets used for unregulated services would form part of the opening RABs which were based on previous jurisdictional valuations. The MCE adopted the same approach to codifying the opening RABs in chapter 6, though it does not appear the MCE intended this to result in standard control customers paying 100 per cent of the cost of assets used for regulated and unregulated activities. Rather, it appears the MCE considered this issue could be addressed through cost allocation. In response to a stakeholder submission on this issue, the MCE stated:

> The standard practice will be for the unregulated portion of the asset to be excluded from the regulatory asset base, which currently cover standard control services. [MCE SCO] considers that this process is appropriate for the purposes of cost allocation. The transitional arrangement for Queensland distribution businesses will appropriately address this.[98]

The current cost allocation method (CAM) approach does not apply to non-distribution services. Further, addressing this issue through a cost allocation approach could only apply to future assets not existing assets. Finally, while a CAM assists in preventing users paying costs associated with the provision of non-standard control services, it does not allow users to share in any benefits from standard control assets being used for other purposes.

For clarity, the proposed rule will not result in the AER being able to set the prices of unregulated services. Rather, the proposed rule aims to compensate users for the use of standard control assets in the provision of other services.

The proposed rule will also provide a mechanism to allow the AER to address the issue of shared assets for Queensland after the transitional provisions expire at the end of the current regulatory control period.

[98] SCO, *SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6)*, p. 15.

6.10 How the proposed rules contribute to the NEO and revenue and pricing principles

The proposals outlined in this chapter contribute to the NEO in a number of ways. In particular, they seek to ensure that consumers are only required to pay for efficient expenditures that have been subject to robust regulatory consideration.

The proposals address the features of the current regime that lead to upwardly biased expenditure forecasts and the restrictions on the AER's ability to respond to this bias. They also allow the AER to consider a broader range of relevant information when it determines the efficient overall expenditure forecast. At the same time, the proposed framework protects NSPs against the risk of forecast error by building an appropriate level of flexibility into the regulatory framework—for instance in relation to capex reopeners and contingent projects.

The proposed rule change also improves incentives on NSPs to invest efficiently in their networks:

- the proposed overspend sharing mechanism establishes incentives on NSPs to invest only when it is efficient and prudent to do so. By increasing the level of discipline on capex in excess of forecasts, the proposal contributes to the NEO by reducing unnecessary upward pressure on customer prices

- the rules relating to future incentive schemes will give the AER flexibility to design a balanced overall incentive framework to respond to different types of NSP behaviour as they arise and to incorporate new ideas, which in turn will provide NSPs with more effective and balanced incentives to promote economic efficiency.

The proposal addresses features of the current regime that unduly favour NSPs:

- the proposed rules relating to profit margins and capitalisation changes will restrict NSPs' ability to artificially inflate the amount of 'actual capex' reported for the purposes of performing the RAB roll forward

- the proposed treatment of shared assets will allow consumers, as well as NSPs, to benefit from the use of regulated assets for non-regulated purposes

- by giving the AER discretion to apply forecast depreciation to roll forward the asset base at the end of a regulatory control period under chapter 6A of the NER will help to ensure that TNSPs are not rewarded for cost reductions that do not reflect efficiencies

Finally, the proposed changes reduce the administrative costs associated with regulatory decision making. The overall cost of regulation includes the resources and time expended by the regulator, service provider and interested parties. For instance:

- by reducing the overall level of prescription in, and improving the clarity of, the expenditure factors the rule change proposal reduces the cost of regulation and provides an opportunity to focus on the key factors that drive expenditure

- by establishing clear thresholds that must be met before the AER will consider varying a determination, the proposals relating to cost pass throughs minimise the administrative cost associated with regulatory decision making and create incentives for NSPs to focus on efficiently operating and investing in their networks.

6.11 Expected costs and benefits and the potential impacts on those affected

Overall, the AER considers that there are significant net benefits associated with the package of rule change proposal described in this chapter. The changes would establish a regulatory framework which is better equipped to identify and reward efficient expenditure, while minimising inefficient expenditure which adds to customer bills.

The AER's proposal seeks to achieve a balance between the interests of consumers and NSPs which aligns with the revenue and pricing principles. The key beneficiaries are consumers since the proposal limits opportunities for NSPs to earn returns above efficient levels. However, the AER has sought to design a balanced package of proposals which benefits NSPs where appropriate. For instance:

- DNSPs benefit from the proposed introduction of capex reopeners and contingent projects in distribution, since their revenue determinations will become more flexible. Consumers would also benefit from the increased security associated with having economic regulation arrangements that respond to unforeseen events.

- TNSPs benefit from the additional flexibility that arises from the proposal to allow the AER to choose whether to apply forecast or actual depreciation, rather than having this prescribed in the rules. TNSPs would be able to avoid the uncertainty of potential windfall loss (or gains) in the event that the AER adopts forecast depreciation when the differences between the actual and forecast outcomes are likely to result from uncontrollable factors. Consumers benefit from the additional flexibility that arises from the proposal which will assist the AER in ensuring a TNSP is not rewarded for cost reductions that may not reflect efficiencies.

- Streamlining the process associated with the introduction of new incentive schemes, and removing the obligation to apply certain schemes to TNSPs, has the potential to benefit the AER, NSPs and other relevant parties. NSPs would also have the opportunity to be rewarded if their performance is above the criteria set by the schemes.

7 Determination of the rate of return

7.1 Introduction

This section outlines the proposed rule changes to the weighted average cost of capital (WACC) provisions in the NER. The majority of these changes seek to streamline the process and provide certainty for setting the WACC for NSP, as well as for gas pipelines.[99] The changes also seek to provide the AER more flexibility to address unforseen and undesirable outcomes in the setting of the debt risk premium (DRP) that have arisen recently.

The current arrangements under the NER in relation to the determination of the WACC differ between electricity distribution and transmission NSPs. In particular, while both chapters 6 and 6A require periodic 'WACC reviews', chapter 6 requires the outcomes of such reviews to be published in a statement of regulatory intent (SORI) which can be departed from in each distribution determination in the presence of 'persuasive evidence'. Conversely, in chapter 6A, WACC review outcomes cannot be departed from in transmission determinations.

The WACC review covers the following values, credit ratings and methodologies:[100]

- the nominal risk-free rate
- the equity beta
- the expected market risk premium (MRP)
- the market value of debt as a proportion of the market value of debt and equity (i.e. the gearing ratio)
- the credit rating levels to calculate the debt risk premium (DRP)
- the assumed utilisation of imputation credits (i.e. gamma) used to calculate the estimated cost of corporate income tax.[101]

Use of the nominal post-tax framework and the capital asset pricing model (CAPM) are prescribed in the NER and are not subject to the AER's WACC review.

Under chapter 6, the first WACC review was to be completed by 1 May 2009 and at intervals not exceeding five years after 31 March 2009.[102] Under chapter 6A, the intervals for review also commenced from 31 March 2009 but are exactly five years.[103]

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99 This chapter should be read in conjunction with the AER's rule change proposal with respect to the *National Gas Rules* given the similarity in issues in setting the WACC for both gas pipelines and electricity networks.
100 Collectively referred to hereafter as 'parameters'.
101 NER, cll 6.5.4 and 6A.6.2(f)–6A.6.2(j).
102 NER, cl 6.5.4(b).
103 NER, cl 6A.6.2(g).

7.1.1 Overview of issues with the current rules

There are benefits and drawbacks of the different approaches to setting the WACC under chapters 6 and 6A. However, the process applied in chapter 6A has the least drawbacks. The materiality of the rate of return in determining revenue requirements and end use prices, combined with the inherent uncertainties involved in determining individual parameters, provides fertile ground for ongoing and often irreconcilable debate between stakeholders and the AER. This is despite most WACC parameters being slow to change with developments in data and theory.

More generally there appears to be little justification for having different arrangements in setting the WACC between electricity DNSPs and TNSPs and gas networks. The WACC is a benchmark and is largely independent of business/ industry specific considerations.

For many parameters, the current rule framework in chapter 6 provides for the AER and DNSPs to be in continual ‘WACC review’ mode where considerable resources are spent at every determination process re-examining issues. The incentive for DNSPs to argue with the AER has also resulted in reviews by the Australian Competition Tribunal in pursuing a level of precision which can only be considered spurious in the context of many WACC parameters. Moreover, where the AER has undertaken a thorough review in the context of chapter 6A and made an overall decision which reflects the views and interests of all stakeholders, it remains open for DNSPs to cherry pick those component parameters of the WACC which they consider unfavourable for them. This process detracts from the AER’s ability to adequately consider the resulting overall rate of return.

The current rules provisions have also given rise to difficulties in setting allowances for the cost of debt. The NER prescribe that the AER must refer to a benchmark corporate bond rate, the yield of which in practice bears little resemblance to what would be an efficient cost of debt for electricity networks. In part this reflects the AER’s decision to set a benchmark yield to maturity of 10 years, which became immediately problematic during and after the global financial crisis when the market for long dated bonds was highly limited.

The restrictive nature of this DRP definition has resulted in significant debate and merits review processes that have focussed on technical arguments around an appropriate choice of data to satisfy the benchmark definition rather than how best to achieve outcomes that are in the long term interests of consumers. In this regard, the benchmark debt margins proposed by networks have been as high as 4.6 per cent[104] above the risk free rate while market data suggest that margins on debt issued by companies during and after the global financial crisis (GFC) have ranged from 1.8 to 3.6 per cent.[105] If the AER were to set its DRP at levels closer to the electricity networks’ current actual cost of borrowing, resulting in a conservative reduction in approved margins of, say, 1 per cent, this would result in consumers paying

[104] NT Gas, *Access Arrangement Revision Proposal Submission*, May 2011, p. 72.
[105] See Table 7.5 below.

approximately $400 million less to electricity networks in 2011, with this saving increasing in line with additional investments in new assets each year.[106]

7.1.2 Overview of rule change proposal

The AER proposes a series of rule changes to align the processes for determining the rate of return across all electricity networks. The AER's proposal is a process that includes:

- periodic 'WACC reviews', the outcomes of which cannot be departed from in subsequent regulatory determinations (as per the current arrangements for TNSPs)
- no persuasive evidence test at the time of each WACC review, rather, a requirement that the AER have regard to previously adopted values in tandem with all other NER and NEL requirements, rather than being potentially bound to previous values
- increasing the scope of the WACC review to cover the methodology for setting the DRP
- alignment of provisions relating to the timing of WACC reviews across chapter 6 and 6A, namely allowing AER to initiate reviews before the expiry of a five year interval (as per the current arrangements for DNSPs).

These changes are limited in number but would deliver significant improvements in the process of how the rate of return is determined, and also provide a better balance between flexibility and certainty in this aspect of economic regulation.

7.2 The status of the WACC review in determinations

7.2.1 Current Rules

Chapter 6A requires that the parameters determined in the WACC review must be applied in transmission revenue determinations, with no ability to depart from these parameters. However, chapter 6 requires the AER to publish a Statement of Regulatory Intent (SORI) specifying these parameters, which must be applied in distribution determinations unless there is persuasive evidence justifying a departure from a particular parameter.

7.2.2 Nature and scope of issues with the current rules

In identifying the issues the AER has experienced in applying the current rules, it is worthwhile revisiting the justifications of the AEMC and the Ministerial Council on Energy (MCE) in drafting chapters 6 and 6A.

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[106] Based on forecast values in existing determinations, the regulatory asset bases of electricity networks in the NEM were valued at approximately $67 billion as at 2011, of which $40 billion is debt funded according to the AER's benchmark gearing assumption of 60 per cent.

The AEMC's considerations in codifying the WACC review outcomes in the current chapter 6A were as follows:

- there was a high degree of stability in parameter values adopted by the regulator in the years leading up to the AEMC's review
- the savings in administrative costs and reduced uncertainty through codifying WACC parameters would offset any expected benefits of a reassessment of the WACC at every transmission determination
- having short term stability in WACC parameters would create a more stable investment environment
- sufficient flexibility to account for developments in theory and market conditions should be provided through a periodic review of WACC parameters by the AER, subject to any discretion and judgment being exercised in accordance with clear criteria.[107]

On the other hand, the MCE's decision to allow departures from WACC review outcomes at each distribution determination under chapter 6 of the NER was based on the pre-existing differences in WACC parameters across jurisdictions at the time:

> SCO considers that given the different parameters adopted by jurisdictions to date, it is appropriate not to replicate the AEMC transmission rules and allow distribution to converge, should the AER consider it appropriate, over time.[108]

While the AEMC's scope in conducting its review was limited to electricity transmission, the AER's experience has shown that its considerations are relevant to both DNSPs and TNSPs. Importantly, the savings in administrative costs and improved investment outcomes for TNSPs considered by the AEMC would be far greater in the context of distribution where there are more regulated networks. More generally, there appears to be no justification for having differences across sectors with regards to the legal requirements and other processes for setting the WACC, given the rate of return is predominantly based on market and sector wide benchmarks. An unintended consequence of having different WACC frameworks is that they could produce different benchmark parameters when the risks of investment reflected in these parameters should be the same between TNSPs and DNSPs, resulting in investment distortions between sectors.

Another implication of having a WACC review that was concurrent for electricity TNSPs and DNSPs, and also performed under effectively identical NER provisions referring to a benchmark rate of return, was that it resulted in an immediate convergence in parameters from previous jurisdictional outcomes. Hence as a result of the AER's 2009 WACC review decision, the MCE's rationale for different WACC frameworks falls away. It is important to note that the AER's 2009 WACC review could have resulted in different parameters being determined for TNSPs and DNSPs, but this does not imply that separate rule provisions or processes for setting the

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107 AEMC, *Rule Determination*, 16 November 2006, p. 83.

108 MCE SCO, *Response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing*, p. 16.

WACC should apply, nor does it detract from the benefits of being able to consider whether there is a need for different parameters between TNSPs and DNSPs (or gas service providers) as part of a single WACC review process.

The MCE also commented that regulators should be able to adopt a presumption that previous WACC parameters were appropriate, subject to persuasive evidence to the contrary.[109] This was noted in the context of:

> …reviews over inputs into the estimation of the WACC over which there is substantial statistical uncertainty (the concern being that the lack of precision in parameter estimates could give rise to substantial variation in rates of return merely from different interpretations of the same set of data).[110]

The AER's experience with consultation and analysis presented in the WACC review, and during subsequent determinations for gas and electricity networks, is that all WACC parameters are subject to debate stemming from inherent uncertainty in their estimation and because of different and sometimes conflicting theoretical arguments. Specific observations in this context include:

- given that the return on capital contributes approximately half of regulated revenues for each network, there is a strong incentive for NSPs to propose values that are to their advantage
- the consideration of whether there is persuasive evidence does not discourage DNSPs from attempting to cherry pick certain parameters and engage in arguments even where evidence is not persuasive, or to repeat and repackage data and theoretical arguments at each distribution determination. For example:
    - certain arguments on the MRP are repetitive and mostly concern matters the AER has previously considered rather than developments in theory or empirical analysis[111]
    - again with respect to the MRP, NSPs continue to cite a variety of events including earthquakes in Japan and New Zealand[112] as well as selected reports from market commentators which convey a pessimistic outlook for

109 MCE SCO, *2006 Legislative Package: Initial National Gas Rules*, Explanatory material attached to Energy Market Reform Bulletin No.74, November 2006, p. 20–1.

110 MCE SCO, *2006 Legislative Package: Initial National Gas Rules*, Explanatory material attached to Energy Market Reform Bulletin No.74, November 2006, p. 20.

111 For example Officer and Bishop's implied volatility and 'glide path' approach was first presented during the AER's WACC review and not relied on given the lack of supporting information provided to the AER at the time. It has since been presented to the AER (and rejected as a basis for estimating the MRP) in electricity distribution determination processes for ETSA Utilities and the Victorian DNSPs, as well as in the AER's gas access arrangement processes for QLD, SA and NT.

112 For example, APT Allgas Energy Pty Limited, *Access Arrangement Response to AER draft decision 01 July 2011 – 30 June 2016*, p. 18.

the global economy[113], without any substantiation on how this relates to the long run MRP.[114]

In developing chapter 6, the MCE considered that uncertainty in parameters should be supported by a higher threshold of 'persuasive' evidence that should provide a degree of inertia in departing from previously adopted parameters. However, the ability to depart from a previous parameter in light of persuasive evidence produces a risk of higher than efficient rates of return when viewed in combination with other features of the decision making framework:

- when combined with the primacy of the NSP's regulatory proposal in the determination process, the persuasive evidence test draws the AER into arguments posed by NSPs on specific parameters, rather than considering changes in other parameters that may not be in the NSPs' favour

- NSPs are afforded multiple opportunities to argue for parameters of their choice, as they actively participate in the WACC review, provide submissions on other determination processes[115] and then argue again in their own determination processes

- given the technical and ongoing nature of arguments, consumers and other stakeholders may find it difficult to debate WACC issues at every network determination.

Stakeholder engagement is better achieved where all parameters are open for debate in a single focused consultation process, where all affected parties are incentivised to participate and devote resources.

In summary, the current arrangements in chapter 6 have the following drawbacks regarding the ability to depart from the SORI:

- networks are incentivised to continually repackage arguments and data which have been previously considered by the regulator

- where new information or theory does arise, it is slow to evolve and does not warrant the high administrative and opportunity costs of continually reviewing certain parameters under the current framework

- the assessment of persuasive evidence is asymmetric and detracts from the AER's (and the Tribunal's) ability to determine whether the overall rate of return is a reasonable outcome.

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[113] For example, Jemena Electricity Networks (Vic) Ltd, *Regulatory Proposal 2011-15*, November 2009, pp. 167–8.

[114] The AER's recent decision to set a MRP value of 6 per cent has now been subject to a review application by Envestra under the NGR. While this framework does not include a persuasive evidence test, as the MRP is a market wide parameter the arguments presented to the AER have been identical for gas and electricity networks in the wake of the 2009 WACC review. For this reason the outcomes of this review under the NGR are likely to have a significant bearing on the AER's decisions under the NER.

[115] See for example, SP AusNet and Multinet submissions on the market risk premium in the Envestra and APT Allgas access arrangement determinations.

7.2.3 Proposed Rules

The proposed rules remove the ability to depart from the SORI when making distribution determinations, thus making the WACC review outcomes prescribed for all electricity NSPs. This involves removing the persuasive evidence test and related clauses from chapter 6 so that all the parameters determined during the WACC review are prescribed at the time of distribution determinations, as is currently the case for TNSPs. In essence the AER's proposal is to amend the WACC review provisions in chapter 6 to mirror those in chapter 6A.

As the WACC review outcomes would no longer be a statement of intent under chapter 6, the AER proposes to rename the document which prescribes WACC review outcomes as a 'Statement on the Cost of Capital'.

Table 7.1 Summary of proposed rule change: the cost of capital, review and the statement on the cost of capital

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.22] [6A.23] [6A.27] [6A.29]	6.5.2(b) 6A.6.2(b) 6A.6.2(f), (h)	6.5.2(b) 6A.6.2(b) 6A.6.2(h), (i)	Revision to: – clarify the chapeau of clauses 6.5.2(b) and 6A.6.2(b); – require that the weighted average cost of capital is to be calculated in accordance with the statement on the cost of capital; and – require that the statement on the cost of capital only applies to a regulatory or revenue proposal submitted after it is published and if so, a distribution determination or transmission determination must be consistent with the statement.
[10.8]	See Part C, Table 3.1	See Part C, Table 3.1	Revision to replace definition of statement of regulatory intent with statement on the cost of capital.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.9 and 2.6 in Part C. Consequential revisions to the relevant definitions in Chapter 10 are set out at Table 3.1 in Part C.

7.2.4 How the proposed Rules address the identified issues

The AER agrees with the AEMC's reasoning, when developing chapter 6A, that prescribing WACC review outcomes for transmission determinations reduces administrative costs and increases investment certainty. The AER's proposed rule changes seek to achieve the same objectives for electricity distribution processes.

Consistency in WACC rule provisions was also considered as a possibility by the MCE in developing chapter 6.

The proposed rule changes would avoid investment distortions across different networks by applying the same benchmark WACC parameters in each regulatory price determination for which the statement on the cost of capital applies.

In administrative terms, moving considerations of WACC matters from the regulatory determination process into a separate periodic review provides further benefits by allowing parties to focus their attention on other elements of the determination process.

7.3 Role of the persuasive evidence test and previously adopted values

7.3.1 Current Rules

The current rules contain two instances of a ‘persuasive evidence’ test:

- at the time of the WACC review—both chapters 6 and 6A provide that where a WACC parameter ‘cannot be determined with certainty’, the AER must have regard to the ‘need for persuasive evidence’ before adopting a value or method that departs from the previously adopted value or method for that parameter[116]

- at the time of distribution determinations—chapter 6 provides that the AER must adopt the WACC parameters from the applicable SORI unless there is ‘persuasive evidence’ to do otherwise.[117]

This section deals with the persuasive evidence test that applies at the time of each WACC review. The persuasive evidence test that applies at the time of each distribution determination would be removed as a consequence of prescribing WACC review outcomes for DNSPs (as discussed in section 7.2).

7.3.2 Nature and scope of issues with the current rules

The persuasive evidence test represents a problematic and potentially unnecessary threshold which may inappropriately restrict the AER’s ability to determine an efficient benchmark rate of return.

In the absence of a persuasive evidence test, the AER would still have regard to the previously adopted parameters as part of its WACC considerations. In the electricity context, the ACCC and jurisdictional regulators have had regard to previous WACC parameters as a matter of good regulatory practice and in the absence of any explicit requirement to do so. This is also the case for the AER in respect of gas access arrangements.[118]

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116 NER, cll 6.5.4(e)(4), 6A.6.2(j)(4) and 6A.6.4(e).

117 NER, cll 6.5.4(g)–(i).

118 As an additional example, during the WACC review, the AER had regard to the previously adopted equity beta and gamma values from previous gas access arrangements (taking into account potential differences between the electricity and gas sectors), while not an explicit requirement of the NER to do so. AER, *WACC Review Final decision—Electricity transmission and distribution network service providers—Review of the WACC parameters*, May 2009, pp. 241–243, 396–397.

The difficulties of interpreting the term 'persuasive evidence' were demonstrated during the WACC review, when a number of stakeholders provided various points of view. Gilbert and Tobin lawyers stated the provision is sometimes referred to as incorporating an 'inertia principle', to reflect the proposition that an existing value or method that has been adopted should not be departed from unless there is persuasive evidence.[119] Other substantive issues raised were whether:

- persuasive evidence is limited to evidence that proves the previously adopted parameter is 'incorrect'
- unanimous evidence is required among experts before the evidence can be considered persuasive
- persuasive evidence is limited to 'new' evidence
- the upper or lower 95 per cent confidence interval (depending on if the market estimates are below or above the previously adopted parameter) is the threshold that determines whether empirical evidence is persuasive or not.[120]

The AER highlights, in particular, the view that the proper interpretation of the persuasive evidence test is one that requires demonstrating a previously adopted parameter is 'incorrect' before the parameter may be departed from. This was a position held by a number of stakeholders including the Joint Industry Association, Gilbert and Tobin and NSW Treasury.[121]

A requirement that previous parameters must be 'incorrect' results in a substantially high threshold before a departure is permitted. The AER did not accept that the threshold was this high.[122]

That said, there is uncertainty around how a Tribunal or Court may interpret this provision. This uncertainty is heightened given the lack of useful judicial interpretation of this phrase either before or since the WACC review and the substantially different positions of the AER and other stakeholders at the time of the WACC review.

While not commenting specifically on the persuasive evidence test in chapter 6, the Tribunal (in its 2011 decision regarding gamma for the QLD and SA DNSPs) commented on the relative importance of inertia with respect to the revenue and pricing principles:

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119 Gilbert and Tobin, *Legal opinion 1*, 22 September 2008, p. 3.

120 AER, *Final decision—Electricity transmission and distribution network service providers—Review of the WACC parameters*, May 2009, pp. 88–89.

121 ibid., pp. 87–89.

122 ibid., p. 89. Instead, the AER considered that 'Persuasive evidence is likely to include objective and verifiable empirical market evidence, and theoretical reasons, so long as they are well founded. The AER's view is that persuasive evidence refers to material which is of sufficient substance to justify a departure from the previously adopted value, method or credit rating. In order to form a view as to whether persuasive evidence exists the AER has considered all the relevant material before it.': pp. 91–92.

> The Tribunal accepts that due regard should be given to historical consistency in applying regulatory values over time. Nevertheless, the Tribunal, standing in the AER's shoes, is inescapably required to exercise regulatory judgment in determining the appropriate value of theta.
>
> The Tribunal must determine an appropriate value for gamma on the basis of the material before it. It does not accept that its task is to determine a value of gamma that is appropriate and not too different from the previously determined value of gamma. That gives too little policy weight to the objective set out in s 7A of the NEL that a regulated DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs. That objective must outweigh any presumption of regulatory inertia.[123]

The Tribunal's comments highlight the need for the AER to be able to consider the relative importance of previously determined WACC parameters in exercising its discretion.

Consideration of past regulatory outcomes in light of current evidence is good regulatory practice. However the codification of this requirement in the persuasive evidence test has the potential (depending on how the relevant provisions are interpreted) for undue weight to be placed on consistency with previous regulatory outcomes at the expense of setting parameters that are appropriate or otherwise in accordance with the interests of stakeholders.

The need for a persuasive evidence test was not intended to be of general application. Rather, the current rules provide that application of the test is conditional on a parameter not being determined with 'certainty', which presumes that some parameters may be determined with certainty. This is not the case, however, as the AER's experience is that none of the WACC parameters can be determined with certainty.[124] This inherent lack of certainty therefore necessitates the exercise of judgment in using market data and other evidence in forming a position on the appropriate WACC parameters.

In particular, it is important that this lack of certainty and the need to exercise judgment does not result in undue regard being placed on consistency with previous regulatory outcomes.

7.3.3 Proposed Rules

The proposed rules remove the persuasive evidence test that applies at the time of the WACC review. Instead, the AER should only be required to have regard to previously adopted parameters in making its decisions. This would require amendment to the list of matters the AER is required to have regard to under the existing clauses 6.5.4(e) and 6A.6.2(j).

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123 *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9 (12 May 2011), [36] and [37].

124 AER, *Final decision—Electricity transmission and distribution network service providers—Review of the WACC parameters*, May 2009, p. 88.

Under the proposed rules, the list of factors (WACC review factors) the AER would have regard to in undertaking a WACC review would be slightly amended to include the following:

- the need for the rate of return to be a forward looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing standard control services
- the need for the return on debt to reflect the current cost of borrowings for comparable debt
- the previously adopted method or value
- the need to achieve an outcome that is consistent with the national electricity objective
- the need for values or methods that vary according to the efficiency of the electricity network to be based on a benchmark efficient network.

Table 7.2 Summary of proposed rule change: the cost of capital, removing persuasive evidence

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.24] [6A.26]	6.5.4(e)(4)(i) 6.5.4(e)(4)(ii) 6.5.4(e)(5) 6.5.4(g)–(i) 6A.6.2(j)(4) 6A.6.4(e)(1) 6A.6.4(e)(2)	6.5.4(e)(4) 6.5.4(e)(5) 6.5.4(g) 6A.6.2(g)(4) 6A.6.2(g)(5)	Revision to: – remove the reference to the need for persuasive evidence before adopting a different value or method of calculating a parameter which cannot be determined with certainty; and – preserve the requirements that in undertaking a review, the AER must have regard to the previously adopted value or method and the national electricity objective.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.9 and 2.6 in Part C.

7.3.4 How the proposed Rules address the identified issues

The proposed rules remove uncertainty around the interpretation of the ‘need for persuasive evidence’. Requiring the AER to instead ‘have regard to’ the previously adopted WACC parameters means that the AER will be required to take these matters into account and give weight to them as one fundamental element in making its decision. The weight to be given to the matters will be for the AER to determine, provided that the consideration of the matters is genuine.

The AER recognises the importance of predictability and consistency in regulatory outcomes. At the same time, given small changes to the WACC can lead to significant price changes, it is also important that undue regard is not given to consistency with previous regulatory outcomes to the detriment of other relevant considerations, in particular setting an appropriate benchmark rate of return.

The AER considers that predictability and consistency are important considerations over the short to medium term, and are best achieved by conducting an industry-wide WACC review on a 'first principles' basis and then prescribing the outcomes of this review for transmission and distribution determinations for a specified period of time. Removing the persuasive evidence test will simplify the AER's decision making process without detracting from the AER having appropriate regard to the benefits of consistency over the longer term at each WACC review.

7.4 The timing of WACC reviews

7.4.1 Current Rules

Chapter 6 requires the WACC review to be conducted not later than every five years with the first interval starting on 31 March 2009. In contrast, chapter 6A mandates that the transmission WACC review be completed every five years with the first review on the same date.

7.4.2 Nature and scope of issues with the current rules

Given the significance of WACC review outcomes, the AER's approach during each review would be to comprehensively address issues relating to the rate of return and seek to provide a consistent approach across DNSPs and TNSPs, while at the same time providing a clear statement of the AER's intentions for gas pipelines. Although this was the case for the first WACC review, the current rules leave some scope for inconsistency with respect to the timing of reviews that apply for TNSPs and DNSPs. That is, chapter 6 provides for the AER to initiate a WACC review within a five year interval, which it may need to do under certain circumstances. However, in such a situation the AER would still be required to undertake another review at the five year mark under chapter 6A, resulting in either the AER inappropriately delaying its review under chapter 6, or duplicating its efforts (and potentially the efforts of other stakeholders) within a short period of time.

7.4.3 Proposed Rules

The proposed rules align the provisions relating to the timing of WACC reviews across chapters 6 and 6A by providing for reviews to be completed at least once every five years. Specifically, the AER proposes to amend the timing provisions in chapter 6A to mirror those currently in chapter 6.

Table 7.3 Summary of proposed rule change: the cost of capital, timing of reviews

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.25] [6A.28]	6.5.4(a), (b) 6A.6.2(f), (g) 6A.6.4(c)	6.5.4(a), (b) 6A.6.2(c), (d)	Revision to: – provide that the next review is to be concluded by 1 March 2014 and subsequent reviews within five year intervals thereafter; and – provide that a review must be undertaken in accordance with the distribution consultation procedures, subject to the reference in rule 6.16(e) and 6A.20(e) to 80 business days being read as a reference to 100 business days and that the AER is not able to extend the time within which it is to make the final decision under rule 6.16(g).

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.9 and 2.6 in Part C.

7.4.4 How the proposed Rules address the identified issues

The proposed rules allow the AER to commence a WACC review concurrently for all electricity NSPs prior to a five year interval, and removes the possibility that different WACC reviews could be undertaken at different times for different sectors.

On balance, the AER considers that the ability to commence a WACC review earlier than but at least once every five years, as per chapter 6, is preferable.

7.5 Definition of the debt risk premium

7.5.1 Current rules

One component of the cost of debt as prescribed in the current rules is the DRP. For DNSPs, the meaning of the DRP is specified in clause 6.5.2(e) as the margin between the annualised risk free rate and the observed annualised Australian corporate bond rate for corporate bonds which have a maturity equal to that used to derive the nominal risk free rate, and a credit rating from a recognised credit rating agency. For TNSPs, clause 6A.6.2(e) is the same however specifies a credit rating from Standard and Poor's in lieu of a credit rating from a recognised credit rating agency.

Aside from this, the current rules do not specify how to estimate the observed annualised Australian benchmark corporate bond rate.

As part of the WACC review, the AER is able to review the term of the risk free rate and the benchmark credit rating.

7.5.2 Nature and scope of issues with current rules

The current definition of the DRP significantly constrains the AER's ability to set an efficient cost of debt which is consistent with the NEO and the revenue and pricing principles. In particular, the reference to a benchmark bond with a particular term to maturity, credit rating and domicile of the issuer bears little resemblance to the financing practices of NSPs and other behaviours of NSPs to minimise their cost of debt.

While the current rules explicitly define the benchmark corporate bond rate, it is unclear whether the maturity, credit rating and domicile are an exhaustive list of factors, prompting significant debate including through merits review processes. A further issue in applying this benchmark relates to a lack of sufficient market data, hindered by the impact of the GFC on bond markets. These issues are discussed in detail below.

Although discussed in the context of the current rules, the approach adopted by gas pipelines to setting the cost of debt under the NGR has also mirrored the formulation and parameters under the current rules (including the DRP). Accordingly, similar issues with respect to the benchmark for measuring the DRP under the current rules have been considered by the AER in recent gas access arrangements.

Ambiguity in satisfying the definition of the benchmark

Using an appropriate benchmark when setting the DRP is important in achieving the NEO—specifically, to promote efficient investment in electricity services for the long term interests of consumers. For example, a benchmark that results in a return on capital that is too high is unlikely to have sufficient regard to the economic costs of over investment by a network. Alternatively, too low a rate of return is unlikely to have sufficient regard to the economic costs of under investment.

As is currently reflected in the current rules, it is appropriate that the rate of return on capital—a component of which is the DRP—be measured as the return required by investors in a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the NSP. Arguably the rate of return definition implies that the cost of debt must also be measured relative to a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the network.

It is unclear, however, whether the meaning of the DRP in the current rules assumes that a corporate bond yield of a particular credit rating and maturity fully reflects the risks of the benchmark service provider. In the AER's view this may not be the case. When considering how best to set a DRP from available market information, it has been suggested that observed corporate bond yields are affected by factors other than credit rating and term to maturity, including:

- bond size
- liquidity
- credit wrap features
- comparable bond issuances

- market sentiment
- scarcity and desirability of issuer
- industry prospects
- financial status of issuer
- abnormal features.[125]

The impact of these features on observed bond yields is uncertain, hence estimating the benchmark at any point in time from market data requires the use of judgment in considering the impact of these various factors. If the DRP is to be specified, the current rules either need to provide more guidance on how it is to be set, or alternatively, as the AER proposes, should be remove the definition of the DRP in the current rules and be determined in the WACC review.

Inflexibility in dealing with changing market conditions

At the time chapter 6A was drafted, the AEMC stated the meaning of the DRP as specified in the NER largely represented current practice.[126] That practice reflected the market conditions at the time.

Debt markets have, however, since changed, and the benchmark debt portfolio held by NSPs is unlikely to be fairly represented by a corporate bond of a particular maturity. The regulatory framework should be flexible to adapt to what is current practice. Moreover, as benchmark financing structures can change over time, the AER is not simply proposing to replace the existing benchmark (i.e. corporate bond rate) with another, but proposes for this to be considered from time to time in the WACC review. The AEMC did not justify why, when developing chapter 6A, the AER should be able to periodically consider the values or methods of calculating all other WACC parameters except for the DRP.[127]

Critically, finding information on bonds that match or even approximate a ten year term and BBB+ credit rating (as determined in the SORI) is extremely difficult under current market circumstances. For example, the last time an Australian dollar denominated ten year corporate bond with a BBB+ credit rating was issued in the Australian bond market was June 2006. Relaxing these benchmark requirements and examining bonds with different maturities, credit ratings and other non-standard features has also only yielded several bonds (although the number of bonds being

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[125] Oakvale Capital, *Report on the cost of debt during the averaging period: the impact of callable bonds*, January 2011, pp. 2–3.

[126] This may reflect that this method was applied by the ACCC in its Statement of Regulatory Principles, with the AEMC only responding to submissions over the appropriate credit rating. See AEMC, *Draft national electricity amendment (Economic regulation of transmission services) rule 2006—Transmission revenue: rule proposal report*, February 2006, p. 64.

[127] The AEMC recognised the need for the methodology and parameters for the cost of capital to be reviewed periodically, and accordingly, the NER facilitated five-yearly reviews to provide the appropriate flexibility and discretion for the regulator to take account of changes in financial market conditions and developments in finance theory and practice. In regard to the DRP, however, this was limited to consideration of the term to maturity of debt and the associated credit rating.

considered by the AER as approximating the benchmark has been increasing in its recent decisions).[128] Alternative approaches, which depend on comparisons of 'fair value' curves published by Bloomberg and CBASpectrum with market data, have also been affected by these data paucity issues.[129] This raises two issues:

- As recognised by the Tribunal in its ActewAGL decision, there seems little point in attempting to estimate the yield on a bond which is not commonly issued.[130]

- From a practical viewpoint, the limited set of bonds or other measures that match the benchmark in the current rules has resulted in continual debate as to how best to estimate the benchmark. This debate has been at a very fine level of detail and inappropriately focussed on examining bonds of specific credit ratings and maturities (and other features) rather than what is an efficient cost of debt for regulated networks.

The Tribunal recently interpreted the current rules as requiring the DRP to be set in reference to the overall market, and not with regard to the costs of debt measured relative to a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by the network.[131] Specifically, in providing its reasons for its decision in regard to the JGN merits review, the Tribunal stated that, in the context of comparing particular bonds with two potential benchmarks, it would be inconsistent to exclude bonds on the basis that they do not exhibit certain industry characteristics when the benchmark makes no such distinction.[132]

Moreover, based on the Tribunal's interpretation, the AER considers that the only manner in which the NEO and the revenue and pricing principles can reasonably be met is if the costs of debt for an efficient NSP are consistent with the costs of debt in the market more generally.

Relevance of benchmark with respect to actual costs of debt

The benchmark DRP has recently been set at rates significantly above NSPs' actual costs. Analysis using information from market reports shows that the cost of recently issued debt for regulated electricity networks and gas pipelines has been around 2.5 per cent above the risk free rate, as shown in Table 7.5.

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128 For example, see AER, *Final decision–APT Allgas Access arrangement proposal for the Qld gas network–1 July 2011 – 30 June 2016*, June 2011, pp. 139–141.

129 The term to maturity of the fair value curves published by Bloomberg has been declining. The longest term for BBB rated debt (which encompasses the band of BBB–, BBB, and BBB+ rated debt) is now just seven years. CBASpectrum has ceased publication of its BBB yield curve altogether.

130 *Application by ActewAGL Distribution* [2010] ACompT 4 (17 September 2010), [72].

131 *Application by Jemena Gas Networks (NSW) Ltd (No 5)* [2011] ACompT 10 (9 June 2011), [74].

132 ibid.

Table 7.5 Observed debt issuances by owners of regulated electricity networks and gas pipelines

Issuer	Type	Issuance	Maturity	Amount ($'m)	Term	DRP (per cent)	Source
SPI	MTN	Feb 2010	Aug 2015	520	5.50	2.06	1
SPI	MTN	Mar 2010	Mar 2020	100	10.00	2.18	1
SPI	MTN	Mar 2010	Sep 2017	300	7.50	2.09	1
APA Group	MTN	Jul 2010	Jul 2020	300	10.00	2.90	1
SPIAA (Jemena)	MTN	Aug 2010	Aug 2015	500	5.00	2.35	2
DUET Group (DBP)	MTN	Sep 2010	Sep 2015	550	5.00	3.56	1/3
SKI	Bank debt	Sep 2010	Sep 2013	165	3.00	2.28	1
SKI	Bank debt	Sep 2010	Sep 2014	85	4.00	2.58	1
ETSA	MTN	Mar 2011	Sep 2016	250	5.50	1.81	1
SPI	MTN	Mar 2011	Apr 2021	250	10.01	2.18	1
DUET Group (UED)	Bank	Apr 2011	Apr 2014	380	3.00	2.14	1/3
DUET Group (UED)	Bank	Apr 2011	Apr 2018	120	7.00	3.06	1/3
Average spread						2.43	

Sources: 1 – ASX, 2 – Newspaper Release, 3 – Merrill Lynch. AER analysis.

The debt listed in this table has been raised at margins of between 1.8 and 3.6 per cent and an average of approximately 2.4 per cent. In contrast, the AER has approved DRP values of between 3 and 4 per cent in its gas and electricity determinations since the beginning of 2010 (of fourteen determinations, ten have been subject to review applications).[133]

These approved values also compare to recent DRP estimates provided by IPART and the ERA of approximately 2.9 and 3.1 per cent respectively.[134] While the AER acknowledges the different frameworks applicable to these decisions, the difference of up to 1 per cent is significant.

7.5.3 Proposed rules

The proposed rules removes the definition of the DRP and provides for it to be determined during the WACC review.

In considering the removal of the DRP definition, the AER also proposes to remove the NER definition of the nominal risk free rate and values for other parameters

[133] Those that were not reviewed with respect to the DRP were for NT Gas and the QLD/SA electricity DNSPs.

[134] IPART, *Developing the approach to estimating the debt margin, Other Industries—Final decision*, April 2011, ERA, *Draft decision on proposed revisions to the access arrangement for the Dampier to Bunbury Natural Gas Pipeline*, 14 March 2011.

mentioned in chapter 6A as these have been superseded as the result of the 2009 WACC review and are therefore redundant.

Table 7.4 Summary of proposed rule change: the cost of capital, removing prescription regarding the nominal risk free rate, the debt risk premium, the equity beta, the market risk premium, the value of debt as a portion of equity and the assumed utilisation of imputation credits

No.	Existing rule(s)	Proposed rule(s)	Remarks
[6.23] [6A.24] [6A.25]	6.5.2(c)–(e) 6A.6.2(b)–(e) 6A.6.4(a)	6A.6.2(b) 6A.6.4(a)	Revision to – remove the prescription on how to calculate the nominal risk free rate and the debt risk premium; and – remove references that deem the value of the equity beta, the market risk premium, the market value of debt as a proportion of the market value of equity and the assumed utilisation of imputation credits.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.9 and 2.6 in Part C.

7.5.4 How the proposed rules address the identified issues

Removing the definition of the DRP from the current rules, and instead consulting on it during the WACC review, will allow the AER to better determine an efficient cost of debt. Once a definition and methodology is set out in the statement on the cost of capital, it will also provide clarity and certainty for stakeholders for the life of that statement. This contrasts with the current environment, whereby the AER is continually drawn into debating the DRP and the associated methodology/ data at every electricity and gas access arrangement determination.

The need for increased flexibility in the current rules is highlighted by the review of most of the AER’s recent DRP decisions and that these decisions are producing DRPs which are well above the actual cost of debt for many regulated NSPs.

Removal of the previously adopted values for the equity beta, the gearing ratio and the valuation of imputation credits, as well as the methodology for calculating the nominal risk free rate, does not address any particular issues identified with the NER and is proposed only with the purpose of removing redundant provisions.

7.6 How the proposed rules contribute to the NEO and revenue and pricing principles

The proposed rules will strengthen the AER’s ability to approve a rate of return that is commensurate with the regulatory and commercial risks faced by NSPs. Approving such a rate of return will promote the NEO and the revenue and pricing principles by improving the incentives on NSPs to invest efficiently in their networks and by providing them a reasonable opportunity to recover at least the efficient cost of providing direct control network services. The proposed rules achieve this by:

- enabling a consideration of the rate of return framework and individual parameters during a single focussed review, which is not then subjected to cherry picking of individual parameters at each distribution determination

- providing an environment conducive to investment certainty by prescribing how the rate of return is to be determined for the life of the statement on the cost of capital

- providing for the AER to periodically reconsider and amend the definition of the DRP to better reflect the efficient financing practices of NSPs, including as these practices change over time

- removing the persuasive evidence test at each WACC review, enable the AER more effectively balance the desirability of consistency with previously adopted values with the need to set an efficient rate of return that reflects current market conditions and theory.

7.7 Expected costs and benefits and the potential impact on those affected

The proposed rules would result in the following benefits:

- provide more certainty and stability in how the rate of return is to be determined during the life of the WACC review decision, in turn encouraging an environment in which service providers are able to attract more investment

- strengthen the AER's ability to approve an overall rate of return commensurate with the regulatory and commercial risks faced by service providers, rather than a rate of return that is subject to cherry picking of individual parameters and is higher than an efficient level

- reduce the administrative cost for networks, consumers and the regulator associated with regulatory decision making by focusing on a single periodic review of the WACC, as opposed to the current continual review of arguments in distribution determination processes

- reduce administrative costs by removing the potential for having WACC reviews under chapters 6 and 6A, which currently have different timing requirements for reviews

- remove inflexibility around the DRP definition and provide all stakeholders with more flexibility to debate how the AER is to ensure the cost of debt reflects efficient outcomes

- provide a greater balance between the need for the rate of return framework to be flexible to account for changes in circumstances and finance theory over the longer term with greater certainty and consistency in the short to medium term.

However, there are also the following costs that arise from the proposed rules:

- loss of flexibility in dealing with any changes in market conditions and theoretical developments in the short term when setting rates of return for DNSPs
- increased uncertainty for electricity networks at the time of each WACC review, in terms of potential changes in how the DRP is to be estimated.

In terms of other consequences, increased codification and consistency in how the rate of return is determined for electricity networks may affect approaches adopted by the ACCC and other regulators. Such consistency may also aid investors and other external parties in understanding the AER's methods.

The codification of WACC parameters in chapter 6, and hence removing the AER's decision on these parameters in distribution determinations, would also result in such matters not being the subject of merits review. The role and scope of merits review will be appropriately dealt with under the separate process in accordance with section 71Z of the NEL.

8 Regulatory decision-making process

8.1 Introduction

This section outlines the AER's proposed procedural amendments to enhance the efficiency and effectiveness of the regulatory decision making process. These changes do not affect the key elements of the current procedural framework, including:

- a requirement that the AER make transmission and distribution determinations within a fixed (11 month period) timeframe
- a requirement for network service providers (NSPs) to lodge proposals at the commencement of a determination process
- a requirement for the AER to publish a draft decision before reaching a final decision
- an opportunity for NSPs to respond to the draft decision and for other stakeholders to make submissions on an NSP's proposal and the AER's draft decision.

The prescription of these elements in the current rules provides certainty for all stakeholders in how the decision making process will operate and provides for timely decision making. The AER's proposed amendments are focussed on addressing the:

- ability of NSPs to make submissions on their own revenue and regulatory proposals
- identification of and the weight that is to be placed on confidential information
- type of decision to be made by the AER that applies to the assessment of the total revenue amounts set out in a NSP's revenue or regulatory proposal
- matters covered in the framework and approach paper for DNSPs and the extent to which positions formed at this stage are 'locked-in' for the purposes of the distribution determination
- circumstances in which the AER can reopen determinations for material error during a regulatory control period
- timeframes afforded to the AER to make decisions relating to cost pass throughs, contingent projects and capex reopeners
- timeframes afforded to the AER to undertake a review of the cost of capital and to publish a statement on the cost of capital.

The proposed rule changes will ultimately provide greater clarity around these issues and increase the administrative efficiency of the regulatory decision making process.

8.2 Submissions received during a determination process

Under the current rules in chapters 6 and 6A, in addition to submitting a regulatory or revenue proposal, a NSP is afforded the opportunity to make submissions on the AER's draft decision. In practice, many NSPs have used this opportunity to submit information which should have properly formed part of their regulatory or revenue proposals.

8.2.1 Current rules

The current rules:

- specify the content of and information to be included in a regulatory or revenue proposal[135]
- provide for any person to make a written submission to the AER on an NSP's regulatory or revenue proposal or the AER's draft decision[136]
- require the AER to consider any written submissions made on time
- provide that the AER may, but is not required, to have regard to late submissions.[137]

In making its final decision, the AER must consider any submissions on the draft decision, or on any revised proposal submitted.[138]

8.2.2 Nature and scope of issues with the current rules

The objective of the current rules, as envisaged by the AEMC was to encourage NSPs to provide complete proposals which reflect their best available information upfront to allow for effective consultation and for the AER to make timely decisions.[139]

However, this objective has been undermined by NSPs, subsequent to the lodging of their revenue or regulatory proposals (in particular, after their revised proposals),[140] making substantial submissions that contain information which otherwise should have properly formed part of their proposals.[141] To date, this has occurred in two (out of the six) transmission determination and 10 (out of the 12) distribution determination processes. Two specific examples are set out in Box 8.1.

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135 NER, cll 6.8.2(c), 6A.10.1 and 6A.10.2.
136 NER, cll 6.9.3(c), 6A.11.3(c), cll 6.10.3 and 6A.12.3(a).
137 NER, cll 6.10.1 and 6A.12.1.
138 NER, cll 6.11.1 and 6A.13.1.
139 AEMC, *Draft Rule Determination*, 26 July 2006, p. 109; AEMC, *Rule Determination*, 16 November 2006, pp. 110 and 111.
140 Necessarily, the deadline for submissions follows the deadline by when the NSPs are to lodge their proposals; this allows for other stakeholders to comment on those proposals in their submissions.
141 For example, as to the number pages of information made in such submissions: Energex and Energy Australia, over 300 pages; Transgrid and CitiPower, over 150 pages; UED, over 100 pages; and Jemena, over 60 pages. The calculation of page numbers excludes submissions responding to other stakeholders' submissions and submissions made on the negotiated transmission or distribution service criteria.

Box 8.1—Examples of NSP's submissions on their own proposals

CitiPower/ Powercor *(2011–15 Victorian distribution determination)*	CitiPower/Powercor's revised regulatory proposals, in context of the 2011–15 Victorian distribution determination, addressed, in general terms, the AER's position that claims for early debt refinancing were already included in the calculation of direct debt raising costs. Less than 4 pages of general commentary and proposed revised values regarding the appropriate forecast debt raising costs for the forthcoming regulatory period was provided. Subsequent to their revised regulatory proposals, CitiPower/ Powercor made a joint submission on the day submissions closed.[142] This joint submission was technical and contained 33 pages of detailed substantive arguments and over 100 pages of supporting attachments and documentation. This material should have been provided in their revised regulatory proposals. In effect, this denied other stakeholders a proper opportunity to make meaningful submissions on this aspect of their revised regulatory proposals. Other stakeholders would have had approximately one month to prepare submissions on the revised regulatory proposals if they were submitted on 23 July 2010. This also reduced the time between CitiPower/Powercor submitting their substantive revised regulatory proposals and the date the AER's final determination was to be published from approximately 70 to 50 business days.
Energex (2010–15 Queensland distribution determination)	In its regulatory revised regulatory proposals, Energex submitted forecasts of real materials cost escalation of zero (no different to CPI).[143] Subsequently, Energex made a submission on its own revised regulatory proposal outlining an entirely new approach (method and data) to forecast real materials cost escalation. The AER set 16 February 2010 as the due date for submissions on both the draft decision and the DNSPs' revised regulatory proposals. Energex's submission consisted of a 179 page report prepared by Sinclair Knight Merz with a 'final' date 28 January 2010 (13 days after the AER's draft decision) and with a 'date issued' of 5 February 2010. Energex's submission was received by the AER on 15 February 2010, the day before the deadline for submissions.[144] Again, this denied other stakeholders a proper opportunity to make submissions on this issue and reduced the AER's opportunity to robustly analyse material (properly belonging in its regulatory proposals) under the NER's prescribed timeframes.

142 CitiPower & Powercor, *Submission on the AER's draft determination Appendix P: Debt raising costs*, 19 August 2010; CitiPower & Powercor, *Submission on the AER's draft determination Appendix P: Debt raising costs: Statement of Julie Marie Williams*, 19 August 2010.

143 Energex, *Regulatory proposal for the period July 2010 – June 2015*, 30 June 2009, pp. 177–179; and Energex *Revised regulatory proposal for the period July 2010 – Jun e 2015*, 14 January 2010, pp. 17 and 53–59.

144 Sinclair Knight Merz, *Energex forecast materials cost escalation rates for 2010–15 – Final*, 28 January 2010.

This illustrates two issues. First, it denies the opportunity for other stakeholders to consider this further information when making submissions to the AER. In addition, given the tight timeframes prescribed in the NER, this impedes the AER's ability to properly assess the further information.

The ability for stakeholders to consider and make meaningful submissions on revenue proposals is a key component of a well functioning regulatory framework. An unintended consequence of the current drafting of the rules is that stakeholders may be precluded from assessing key information put forward by the NSP.

Secondly, once all of the prescribed consultation requirements are adhered to, the AER is left with less (or arguably insufficient) time to assess any revised regulatory or revenue proposal, take into account submissions and make a final determination.[145] This issue also arises where regulatory or revenue proposals are submitted late.

However, the AER recognises there are circumstances where it is appropriate for a NSP to make a submission. In particular, such a circumstance arises where there are issues common across proposals which are concurrently being assessed by the AER. For example, what should be the methodology for forecasting demand can be an issue common to all NSPs within a particular jurisdiction. An example of a material difference is set out in Box 8.2.

Box 8.2—Example of a material difference on a common issue between concurrent NSP proposals

2011–15 Victorian distribution determination	In the 2011–15 Victorian distribution determination process, a common issue arose as to was what should be the appropriate method to adjust the value of the opening RAB for inflation. Three different approaches were proposed between the five Victorian DNSPs in their regulatory proposals: ▪ CitiPower/Powercor and United Energy Distribution proposed an adjustment of 6 years' of inflation ▪ SP AusNet proposed an adjustment of 6 ½ years' of inflation ▪ JEN proposed an adjustment of 6 ½ years of inflation (although its methodology differed from that of SP AusNet). No Victorian DNSP made a submission on another DNSP's differing approach in this case. However, this is an example of an occasion where it would have been reasonable for them to do so.

The AER considers that where there are material differences in the methodologies, assumptions or reasons applied across concurrent proposals, a NSP should be afforded an opportunity to comment on such material differences if it wishes to before the AER makes its decision.

[145] NER, cll 6.9.3(c), 6.10.2 and 6.10.3(e).

Conversely, where concurrent proposals adopt essentially the same position on a particular matter, NSPs should not be able to submit additional information (under the guise of making a submission on another NSP's proposal) which further supports its own proposal, and which should have otherwise been properly provided in its proposal.

8.2.3 Proposed rules

The AER sought advice from the Australian Government Solicitor (AGS) regarding what amendments, if any, could be made to chapters 6 and 6A to address the issues discussed above. The suggested amendments proposed by AGS have been adopted by the AER in this rule change proposal and are summarised in the following table.[146]

Table 8.1 Summary of proposed rule change: submissions and late proposals

No.	Existing rule(s)	Proposed rule(s)	Remarks
[6.29] [6.30] [6.31] [6A.37] [6A.38] [6A.39]	6.9.3 6.10.1 6.10.2 6.10.3 6.11.1 6.14 6A.11.3 6A.12.2 6A.12.3 6A.13.1 6A.16	6.9.3 6.10.1 6.10.2 6.10.3 6.11.1 6.14.1 6.14.2 6A.11.3 6A.12.2 6A.12.3 6A.13.1 6A.16.1 6A.16.2	Revisions to: – restrict a DNSP or TNSP from making a submission on its own regulatory or revenue proposal and where there are concurrent proposals being assessed, on another DNSP's or TNSP's regulatory or revenue proposal unless there are material differences between the two. – provide for the AER not to consider submissions which do not comply with the restrictions or late proposals. See AGS advice, [26]–[40]; proposed changes [1]–[8].

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.12 and 2.13 in Part C.

8.2.4 How the proposed rules address the current issues

The proposed rules would remove the ability of a NSP to make submissions on their own initial proposal, the AER's draft decision, or their own revised proposal. Accordingly, the mechanism by which NSPs respond to the draft decision would be through their revised proposal (and not through submissions or through a combination of their revised proposal and submissions).[147] The proposed rules would also require the AER to not consider new information in a NSP's revised proposal which goes beyond responding to the draft decision.

[146] AGS, *Advice on possible amendments to the National Electricity Rules*, 27 September 2011.
[147] ibid., pp. 9 and 10.

At the same time, the proposed rules would not restrict NSPs' ability to make submissions on:

- other NSPs' proposals for determination processes that run concurrent to the NSP's own determination process, where those proposals are materially different to the NSP's own proposal[148]
- the AER's proposed negotiated service criteria which is released at the same time as the NSP's initial proposal, or
- submissions from other stakeholders into the transmission or distribution determination process.

Together, these proposed rules would prevent a NSP from making a submission subsequent to and which contained information that properly should have formed part of, their regulatory or revenue proposals. This would ensure that:

- other stakeholders are afforded a proper opportunity to consider all the relevant information prior to making submissions to the AER
- the timeframes prescribed in chapters 6 and 6A for the AER to assess the NSP's revenue or regulatory proposals and stakeholder submissions are not impeded.

The proposed rules would also further encourage NSPs to put forward complete proposal reflecting the best available information, consistent with that envisaged by the AEMC at the time it drafted chapter 6A, and lead to more effective engagement between the AER, NSPs and other stakeholders.[149]

8.3 Identification and use of confidential information

In its 2006 rule determination, the AEMC stated:

> …ensuring revenue cap determinations are subject to open and transparent consultation procedures is a fundamental consideration, but [the AEMC] is also mindful of the importance of ensuring that participants in the consultation process have access to appropriate confidentiality arrangements.[150]

Mindful of the fact that TNSPs would not be able to respond to confidential information in stakeholder submissions that the AER could not publish, the AEMC inserted the current provision enabling the AER to place lesser weight on this information. The AER supports the current provision concerning confidential information in stakeholder submissions.

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148 ibid.

149 AEMC, *Draft Rule Determination*, 26 July 2006, p. 109; see also AEMC, *Rule Determination*, 16 November 2006, p. 110; and AEMC, *Transmission Revenue: Rule Proposal Report – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 – February 2006*, p. 43.

150 AEMC, *Rule Determination*, 16 November 2006, p. 121. The AEMC's comment was in response to a matter raised by the AER in its submission on the draft rules.

Confidential information in a regulatory proposal also risks denying other stakeholders the chance to respond to information to which the AER must have regard. Accordingly, this information lacks the public scrutiny and informed comment that stakeholders may be able to bring to this information.

8.3.1 Current rules

Under the current rules in chapter 6 (similar provisions apply in chapter 6A):

- NSPs are required to give an 'indication' of the parts (if any) of their initial proposal they claim to be confidential. The same requirement does not apply with respect to revised proposals.[151]
- The AER must publish initial proposals and revised proposals, subject to the provisions in the NEL and NER controlling the disclosure of confidential information.[152]
- The AER must publish submissions on an initial proposal or draft decision, but excluding information that has been clearly identified as confidential by the person making the submission.[153] The same requirement does not apply with respect to submissions on a revised proposal.
- The AER may give such weight to confidential information in a submission as it considers appropriate, having regard to the fact that such information has not been made publicly available.[154] There is not an equivalent provision with respect to confidential information contained in an NSP's initial or revised proposal.

8.3.2 Nature and scope of issues with the current rules

The current rules do not provide for the AER to exercise its judgment determining the weight that is to be given to confidential information which is provided in a regulatory or revenue proposal.[155]

There is also a degree of uncertainty as to what the expression 'indicates' means in the current rules.

8.3.3 Proposed rules

The proposed rules would require NSPs to *identify*, instead of *indicate*, any parts of a (revised) regulatory or revenue proposal that is claimed to be confidential. This would provide the AER the discretion to give such weight to confidential information in regulatory (and revised) proposals as it considers appropriate, having regard to the fact that such information has not been made publicly available (as is the case for confidential information in *submissions*).

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151 NER, cl 6.8.2(c)(6).

152 NER, cll 6.9.3 and 6.10.3(d).

153 NER, rr 6.14(c) and 6.14(d).

154 NER, r 6.14(e). This provision does not cover submissions on revised proposals.

155 The only exception to this in the current rules is that in assessing the capex and opex forecasts the AER may give lesser weight to information concerning third party or related party arrangements that the AER considers do not reflect arm's length terms.

Table 8.2 Summary of proposed rule change: confidential information

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.28] [6A.36] [6A.37]	6.8.2(c)(6) 6A.11.3(a) 6A.12.3(f)	6.8.2(c)(6) 6.10.3(c1) 6.14.2(e) 6A.10.1(g) 6A.11.3(a) 6A.12.3(f) 6A.12.3(e)	Revisions to: – introduce new clauses to provide that the transmission network service provider and distribution network service provider must identify the parts of the (revised) revenue or regulatory proposal and any accompanying information that it claims to be confidential; and – introduce new clauses to provide for the AER to give such weight it considers appropriate to confidential information in a (revised) revenue or regulatory proposal.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.11 and 2.11 in Part C.

8.3.4 How the proposed rules address the identified issues

The proposed rules:

- provide the AER with the same discretion to apply an appropriate weight to confidential information in NSP's proposals as it has when assessing confidential information in stakeholders' submissions
- clarify the expression 'indicate' by replacing it with 'identify'.

The first change improves the balance to be struck between confidentiality and transparency, which is already reflected in the current rules which provide for the AER to determine the weight that is to be placed on confidential information provided in submissions.

8.4 Framework and approach paper

8.4.1 Current rules

In anticipation of each distribution determination, the AER must publish a framework and approach paper.[156] Where an existing distribution determination is currently in force, the AER must:

- commence consultation on the paper at least 24 months before the end of the current regulatory control period
- publish the paper at least 19 months before the end of the current regulatory control period.[157]

[156] NER, cl 6.8.1(a).

The framework and approach must state the form (or forms) of control mechanisms to be applied to standard control services and alternative control services. It must also specify the AER's 'likely approach' in the forthcoming distribution determination to:

- the classification of distribution services
- the application of the incentive schemes (STPIS, EBSS and DMIS)
- 'any other matters on which the AER thinks fit to give an indication of its likely approach'.[158]

Additionally, the framework and approach paper must include the AER's determination of whether the chapter 6 pricing framework is to apply to any 'dual function' assets owned, controlled or operated by the DNSP.[159]

The extent to which the positions set out in the framework and approach paper are then binding on the forthcoming distribution determination differ among the above matters. In a distribution determination:

- the control mechanisms and dual function assets determination must be as set out in the framework and approach paper[160]
- the service classifications must be as set out in the framework and approach paper unless the AER considers that, in light of the DNSP's regulatory proposal and submissions received, there are 'good reasons' for departing from these classifications[161]
- positions in the framework and approach paper on the application of the incentive schemes and any other matters are not binding on the AER or DNSP.[162]

8.4.2 Nature and scope of issues with the current rules

There are three key issues with the current framework and approach process, namely that it:

- results in an inefficient three stage consultation process on the development and application of the incentive schemes in distribution
- creates the potential for a mismatch between a particular service classification and the form of control to apply to that service

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157 NER, cl 6.8.1(f).
158 NER, cl 6.8.1(b).
159 NER, cl 6.8.1(ca). A dual function asset is any part of a network owned, operated or controlled by a DNSP which operates between 66 kV and 220 kV and which operates in parallel, and provides support, to the higher voltage transmission network: NER, cl 6.24.2.
160 NER, cl 6.12.3(c).
161 NER, cl 6.12.3(b).
162 NER, cl 6.8.1(h).

- does not strike the right balance between certainty and flexibility regarding the degree to which service classifications and control mechanisms are ‘locked-in’ at the framework and approach paper.

Consultation on distribution incentive schemes

There are currently three stages of consultation on the development and application of each incentive scheme. Three stages are unnecessary and can be reduced to two. Firstly, there is stakeholder consultation during the *development* of each incentive scheme. Then under the current rules, there is further consultation with stakeholders on the *application* of a particular scheme to a particular DNSP during the framework and approach then again during the distribution determination.

The requirement in the current rules to engage in consultation during the development of the framework and approach paper on the application of the schemes is of limited benefit to the DNSPs or other stakeholders. Previous framework and approach processes have yielded a low level of stakeholder engagement on the application of the incentive schemes. Moreover, any positions on the schemes as set out in the framework and approach are not binding—therefore, they may be limited benefit in the level of regulatory certainty they provide.

Specification of the service classifications and control mechanisms

There is no reason why service classifications and the form of control mechanisms are either ‘locked-in’ in the framework and approach paper, or amendable during the distribution determination, should not be the same. However, under the current rules different requirements apply between these two issues.

This creates a potential issue where a service classification may change after the framework and approach paper but there is no form of control mechanism for that changed classification. For example, in the framework and approach paper, the AER might classify no services as alternative control services (and therefore set out no form of control for alternative control services in the framework and approach). If during the distribution determination process, it decided to re-classify some services (e.g. public lighting services from negotiated distribution services to alternative control services), this creates an issue: no form of control mechanism would have been set out in the framework and approach for these services. This illustrates two issues framework and approach paper process in the current rules:

- there is not enough flexibility to amend the formulaic expression of the control mechanism

- there is too much scope for amendments to be made to service classifications.

On the control mechanism matter, the current rules go beyond what is required to promote investment certainty, and limits the AER’s ability to improve the formulaic expression of the control mechanism during the determination process to address issues of lower-order detail that only become apparent during the distribution determination stage.

On the service classification matter, the current rules:

- do not provide enough investment certainty—there is too much scope for the service classifications that are to apply to or regulate metering services, connection services or public lighting services to significantly change after the framework and approach paper
- have the potential to create significant administrative costs on NSPs and the AER—specifically, changing the service classifications during the distribution determination stage would require the opex and capex forecasts to be recast.

8.4.3 Proposed rules

The proposed rule changes:

- remove the requirement to consult on the application of each incentive scheme
- provide that the service classifications and form of control mechanism as specified in the framework and approach paper must be applied in the distribution determination unless these positions are no longer appropriate due to circumstances that were unforeseen at the time of the framework and approach paper.

Table 8.3 Summary of proposed rule change: framework and approach paper

No.	Existing rule(s)	Proposed rule(s)	Remarks
[6.32] [6.33]	6.12.3(b), (c)	6.12.3(b), (c)	Revision to provide for the AER to change the classification of services or the control mechanism from that specified in the framework and approach paper if unforeseen circumstances arise from the regulatory proposal and submissions received.
[6.34]	6.8.1(b)(2)–(4)	Deleted	Revision to remove the requirement for the AER to state its likely approach to application of incentive schemes.

Note: This table is a summary, the complete set of proposed rule changes are set out at Table 1.13 in Part C.

8.4.4 How the proposed rules address the identified issues

The proposed rules allow the specification of the service classifications and control mechanisms to be changed, if necessary, at the distribution determination stage to address matters which were unforeseen at the framework and approach stage. This provides an appropriate degree of investment certainty—by locking in the substantive positions on these matters at the framework and approach stage. At the same time the proposed rule changes enable an appropriate degree of flexibility during the distribution determination to amend matters of detail that often only become apparent at this stage.

There may have been some benefit in consulting on the incentive schemes as part of developing the framework and approach paper during the first round of distribution determinations—as these schemes were applied to the DNSPs for the first time. However, this will not be the case during the second round of determinations. Similarly, the first time a new incentive scheme developed under clause 6.6.5 is applied to DNSP there may be a benefit in including this within the framework and approach paper. The proposed rules facilitate this to occur. The changes simply remove the mandated requirement to consult on every incentive scheme for every DNSP during the framework and approach, as this will not always be warranted.

An alternative to the proposed rules is to lock in the application of the schemes in the framework and approach paper and remove the consultation from the distribution determination stage. The AER has considered this alternative and considers it less desirable than the proposed rule changes because it would not enable matters that were not foreseen at the framework and approach stage to be addressed.

8.5 Correcting for material errors

8.5.1 Current rules

The current rules provide for the AER to revoke and substitute a transmission or distribution determination during the regulatory control period to correct for material errors in the determination.[163] There are two differences in the material error provision between chapters 6 and 6A.

Firstly, the current rules in chapter 6 provide an exhaustive list of what constitutes a material error. These are errors that arise from a clerical error or 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.

Secondly, under the current rules in chapter 6A, the AER may only change the determination to the extent necessary to correct for the error with the exception of errors arising from the provision of false or misleading information where this limitation does not apply. Under the current rules in chapter 6, this limitation applies in all circumstances.

8.5.2 Nature and scope of issues with the current rules

While the AER recognises the benefits of being able to correct for material errors, there are three issues which arise under the current rules:

- first, it is conceivable that a material error may arise from errors outside the scope of the prescribed list of errors in chapter 6
- second, the ability in chapter 6A for the final decision to be changed more than the extent necessary to correct an error, where that error is caused by the provision of false and misleading information, has the potential to undermine the finality of the decision making process by reopening matters not necessary for the correction of the error

[163] NER, rr 6A.15 and 6.13.

- third, in the event an error is to be corrected, the AER is not afforded a power to ‘amend’ a distribution or transmission determination, it is conceivable there may be circumstances where it is more appropriate or preferable to do so rather than to ‘revoke and substitute’ the entire distribution or transmission determination.

As to the third issue, in drafting the current rules in chapter 6A, the absence of such a restriction was rationalised by the AEMC as being:

> …appropriate in these circumstances, as it provides additional incentives on the TNSP to ensure that they do not provide misleading information.[164]

It is not clear that the additional incentives referred to by the AEMC are appropriate. Incentives to not provide false or misleading information already arise under the *Criminal Code Act 1995* (Cth). The *Criminal Code* provides that providing false or misleading information to a Commonwealth entity is an offence to which severe penalties apply.[165]

The AER also considers that once a final decision has been made, preserving the finality of that decision is important to provide certainty for all stakeholders. Accordingly, the capacity of amending or substituting a decision to correct for material errors should be limited to the extent necessary to correct for those errors. It is not appropriate to reassess matters which need not be amended to correct the error.

8.5.3 Proposed rules

The proposed rules:

- remove the matters listed in chapter 6 from which a material error may arise
- provide for the AER to amend, in addition to revoke and substitute, distribution and transmission determinations
- require that all material errors only be corrected to the extent necessary.

Table 8.4 Summary of proposed rule change: amending, revoking or substituting a distribution determination or transmission determination

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.17] [6A.21]	6.13 6A.15	6.13 6A.15	Revisions to provide that the AER may revoke and substitute or amend a distribution determination or transmission determination.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.4 and 2.4 in Part C.

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164 AEMC, *Review of the Electricity and Revenue Pricing Rule s– Transmission Revenue: Rule Proposal Report – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, February 2006, p. 51.

165 *Criminal Code Act 1995* (Cth), s 137.1. See also *Crimes Act 1914* (Cth), s 4B.

8.5.4 How the proposed rules address the identified issues

The proposed rules will provide for the AER to consistently deal with the correction of material errors in chapters 6 and 6A. Further, the proposed rules reduce the uncertainty apparent in the current rules by:

- not limiting the matters a material error may arise from
- requiring all material errors to be only corrected to the extent necessary
- providing the AER with the flexibility to amend, instead of revoking and substituting, a distribution or transmission determination, in circumstances where that is all that is required to correct for the material error.

8.6 Timeframe for the conduct of WACC reviews

8.6.1 Current rules

In developing or amending a guideline, model or incentive scheme, or in conducting the WACC review the AER must follow the transmission and distribution consultation procedures. These procedures require the AER to publish a draft decision (called an 'explanatory statement'), allowing for no less than 30 business days for the making of submissions.

Within 80 business days of releasing the draft decision the AER must publish its final decision, however the current rules in:

- chapter 6 permit the AER to extend the maximum 80 day timeframe between draft and final decisions if the matters are unusually complex or the extension is necessary due to circumstances beyond the AER's control
- chapter 6A do not permit the AER to extend the maximum 80 day timeframe in any circumstance.

8.6.2 Nature and scope of issues with the current rules

The current rules in chapter 6A contains a 'one-size-fits-all' model where the development or amendment of a guideline, model, scheme or WACC statement must be made within the same timeframe, regardless of the complexity of the task at hand.

The nature and scope of issues with the current rules became apparent during the AER's WACC review. This was the first electricity-wide WACC review conducted by an Australian regulator and involved a number of matters of complexity.

In addition, the ability for the AER to extend the 80 day timeframe under chapter 6, but not under chapter 6A, placed a practical constraint on the AER utilising the additional flexibility in chapter 6 if the AER was to conduct a joint transmission / distribution WACC review. This restricted the AER's ability to extend the time period for stakeholder consultation much beyond the required minimum period, while at the same time maintain a sufficient period of time for the AER to properly assess the submissions received.

On the other hand, the AER has found the current timeframe rules for the development or amendment of guidelines, models and schemes to be adequate.

8.6.3 Proposed rules

The proposed rules do not amend the transmission or distribution consultation procedures but instead amend the relevant provisions relating to the review of the cost of capital so that the review would be conducted under the transmission and distribution consultation procedures, subject to the reference to 80 business days being read as a reference to 100 business days, and is not subject to any timeframe extension.

As per the current rules, the AER would be able to release issues papers, discussion papers or other ‘informal’ consultation documents prior to the explanatory statement. The 100 business day maximum timeframe commences on the release of the explanatory statement.

Table 8.5 Summary of proposed rule change: the cost of capital, timing of reviews

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.25] [6A.28]	6.5.4(a) 6A.6.2(f)	6.5.4(a) 6A.6.2(c)	Revision to provide that a review is to be must be undertaken in accordance with the distribution consultation procedures, subject to the reference in rule 6.16(e) and 6A.20(e) to 80 business days being read as a reference to 100 business days and that the AER is not able to extend the time within which it is to make the final decision under rule 6.16(g).

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.9 and 2.6 in Part C.

8.6.4 How the proposed rules address the identified issues

It is important that regulatory decision making, whether in regards to a transmission or distribution determination, in the development or revision of a guideline, or in the formulation of a WACC review, be conducted in a timely manner. How long constitutes a timely manner depends on the complexity of the task and its significance.

Extending the timeframe for the WACC review from 80 to 100 business days is more commensurate with the complexity and significance of the task. It will ensure the continued thoroughness of analysis in the review and permit the AER to set a longer consultation period for stakeholders, where warranted.

At the same time, a fixed 100 business day period rather than allowing an open-ended assessment period promotes investment certainty and ensures timeliness in the decision making process.

8.7 Timeframe for the assessment of cost pass through events, contingent projects and capex reopeners

This section deals only with the timeframe within which the AER must assess an application for a cost pass through, contingent project or capex reopener.

In section 6.6 of this rule change proposal, the AER proposes further rule changes associated with the design of these mechanisms and their applicability across the electricity transmission and distribution sectors.

8.7.1 Current rules

Under the current rules for both transmission and distribution, the AER has 60 business days from the time it receives an application for a positive pass through amount to assess it. If the AER has not made its decision within this timeframe the application is deemed to have been approved. For negative pass through amounts, the current rules do not specify a maximum assessment period.[166]

For contingent projects and capex reopeners—which currently apply only in transmission—the AER must make its decision within 30 business days and 60 business days, respectively, from the time it receives an application.

8.7.2 Nature and scope of issues with the current rules

The AER expects that 60 business days would be an adequate amount of time to assess the majority of pass through applications it might receive. However, for some pass through events, this timeframe will not be adequate to conduct a thorough assessment of the proposal or provide enough time for meaningful stakeholder consultation.

The current chapter 6 rules recognise that the 90 business day timeframe after the date of the pass through event in which a DNSP must prepare and lodge its application will not be appropriate in all circumstances. The AER must extend the time for a DNSP to submit a pass through application if the AER is satisfied that the difficulty of assessing or quantifying the effect of the relevant pass through event justifies the extension.[167] However, there is no similar provision permitting the AER to extend the time for it to assess a pass through application, even if determining the pass through application requires an unusually detailed and complex assessment.

For example, Ergon Energy submitted an application to the Queensland Competition Authority (QCA) to pass through costs associated with Cyclone Larry.[168] Almost nine months after Ergon Energy submitted its revised application, the QCA released its draft decision. In reaching its decision, the QCA considered a report from Evans & Peck. Evans & Peck needed to gather significant additional data from Ergon Energy to assess its application, and provided their final assessment to the QCA on 1 May

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[166] Positive pass through amounts relate to an increase in costs whereas negative pass through amounts relate to a decrease in costs.

[167] NER, cl 6.6.1(k).

[168] QCA, *Final Decision – Cost Pass-through Application from Ergon Energy – Tropical Cyclone Larry*, September 2008, as amended in April 2009, p. i.

2008 (almost three months before the draft decision was released).[169] Submissions were received in response to the QCA's draft decision from Ergon Energy, Origin Energy, and the Queensland Council of Social Services (QCOSS).[170] The final decision on Ergon Energy's application was released in September 2008. This final decision was released over 15 months after Ergon Energy's initial pass through application was submitted and approximately 10 months after its revised pass through application. The 15 month timeframe the QCA required for the Cyclone Larry pass through assessment is approximately 5 times longer than the maximum assessment period permitted under the current rules (60 business days equates to approximately three months).

It is possible that the AER will receive cost pass through applications involving a similar or greater level of detail and complexity. For example, the Victorian Bushfires Royal Commission (VBRC) has made recommendations to reduce the chance of bushfires being started by the electricity system.[171] A safety taskforce has been established who will recommend to the Victorian Government, by 30 September 2011, how two of the VBRC's recommendations should be implemented.[172] These recommendations concern the replacement of SWER lines and 22-kilovolt distribution feeders, and changes to reclose functions at high risk times. The safety taskforce has indicated that the measures to implement these two recommendations could increase average quarterly household bills by between 2–8 per cent.[173] A pass through assessment on this matter, or something similar, would involve a complex assessment of expenditure forecasts, and may require further information from the DNSPs during the assessment period. It is unlikely that a through assessment of these proposals and meaningful stakeholder consultation could all occur within 60 business days.

Contingent projects and capex reopener assessments also must be completed within relatively short binding timeframes set out in the current rules. While these timeframes will be adequate for some assessments, the above difficulties relatively short timeframes can cause for complex pass through applications assessments apply equally to complex contingent project and capex reopener assessments. This is particularly acute for contingent projects where the maximum assessment period in the current rules is only 30 business days.

8.7.3 Proposed rules

Under the proposed rules, the AER would be required to make determinations on positive pass through amounts, negative pass through amounts, contingent projects and capex reopeners within 40 business days of receipt of an application. However, the AER would have the power to extend this timeframe up to an additional 60 business days (i.e. maximum 100 business day assessment period in total) if:

- the assessment involves questions of unusual complexity or difficulty, or

169 ibid., pp. 2–4.
170 ibid., p. 3.
171 Energy Safe Victoria, *Powerline Bushfire Safety Taskforce Consultation Paper*, 29 April 2011, p. 1.
172 ibid.
173 ibid., p. 19.

- the AER requires information further than that submitted by the NSP in its application.

Table 8.6 Summary of proposed rule change: extension of time frames

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.35] [6.36] [6.37] [6A.31] [6A.32] [6A.33]	–	6.6.1(l) 6.6.4(h) 6.6A.2(h) 6A.7.3(k) 6A.7.3(l) 6A.7.1(h) 6A.8.2(h)	Revisions to: – the current provisions, in relation to the AER making (chapter 6) cost pass through decisions; and – introduce new clauses, in relation to the AER making reopening decisions, contingent project decisions and chapter 6A cost pass through decisions, for which the AER must make a decision within 40 business days which can be extended by up to a further 60 business days if the decision involves questions of unusual complexity or if it requires further information.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.14 and 2.9 in Part C.

8.7.4 How the proposed rules address the identified issues

There are competing considerations between expeditious decision making and ensuring enough time is permitted for the AER to undertake a thorough assessment of an application and to allow for meaningful stakeholder consultation. The proposed rules improve this balance compared with the current rules.

The proposed rules set a ‘default’ timeframe of 40 business days for the assessment of positive and negative pass through amounts, contingent projects and capex reopeners. The adoption of this default timeframe will ensure that non-complex and less information intensive applications are assessed expeditiously with the outcomes announced to stakeholders and reflected in prices in a timely manner.

40 business days is a lengthening of the current assessment period for contingent projects (30 business days) but a shortening in the current assessment period for both positive pass through amounts and capex reopeners (both 60 business days). It also introduces a timeframe for the assessment of negative pass through amounts where currently there is not one.

At the same time, the ability for the AER to extend this timeframe:

- only in limited circumstances stipulated in the rules—ensures that longer assessment periods cannot occur for any reason, but only in pre-determined circumstances that have been assessed as warranting a timeframe extension when necessary to facilitate a thorough assessment and meaningful stakeholder consultation

- to a maximum extension of 60 business days—ensures that a discipline is placed on the AER to make a decision in a timely manner, even in respect of complex matters.

8.8 Consequential amendments to process matters

8.8.1 Current rules

Under the current rules in chapter 6A, the AER must make a decision in which the AER either approves or refuses to approve:

- the total revenue cap proposed by the TNSP in its revenue proposal
- the maximum allowed revenue for each regulatory year as proposed by the TNSP in its revenue proposal.

Similar provisions apply under the current rules in chapter 6 with respect to the annual building block requirement for each regulatory year proposed by a DNSP.

8.8.2 Nature and scope of issues with the current rules

The current rules require the AER to *approve* (or refuse to approve) the total revenue amounts—as proposed by a NSP in its proposal. This requirement is not suited to the proposed rules discussed in section 6 given the calculation of these total revenue amounts is comprised of both:[174]

- matters which the AER must *approve* what is proposed by the NSP if it meets the relevant requirements—such as with the depreciation schedules, pricing proposals and negotiating frameworks
- matters which are *determined* by the AER, having regard to what is submitted by the NSP, and in accordance with the relevant requirements—such as with the operating and capital expenditure forecasts.

8.8.3 Proposed rules

The proposed rules would require the AER to determine the opex and capex forecasts, the specification of the contingent projects, and other matters. As a consequence of the proposed rules requiring the AER to *determine* the opex and capex forecasts, the same language in now used in the proposed rules with respect to the AER *determining* the total revenue cap, maximum allowed revenue or annual building block requirement.

[174] The total revenue amounts refer to the total revenue cap, maximum allowed revenue (MAR), or annual building block requirement (as the case may be).

Table 8.7 Summary of proposed rule change: decision making process

No.	Current rule(s)	Proposed rule(s)	Remarks
[6.38]	6.12.1(2) 6.12.3(d), (f)	6.12.1(2), (2A)	Revision to: – remove clause 6.12.3(d) and 6.12.3(f) consistent with the AER now determining the forecast capex and opex and consequential renumbering amendments; – revise clause 6.12.1(2) to provide that the AER is to determine the annual revenue requirement; and – preserve in new clause 6.12.1(2A), that the AER is to accept or refuse to accept the proposed regulatory control period.
[6A.36]	6A.14.1(1)–(8)	6A.14.1(1)–(6)	Revision to clause 6A.14.1 to provide that in a draft and final decision the AER is to: – determine the total revenue cap, the maximum allowed revenue (consistent with determining the forecast capex and opex), any other amounts, values or inputs that it has used in place of those referred to in clause 6A.10.2(b)(9), determine whether actual or forecast depreciation is to be used in establishing the opening regulatory asset base – identify any contingent projects; – approve or refuse to approve the values attributed to the parameters in the applicable incentive schemes, the commencement and length of the regulatory control period, the transmission network service provider's proposed pricing methodology; and – specify the negotiated transmission service pricing criteria.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 1.15 and 2.12 in Part C.

8.8.4 How the proposed rules address the identified issues

The proposed rules are consistent with a framework under which the AER must approve some elements of the building block calculation proposed by NSPs if it meets stated criteria whereas other elements are determined by the AER.

8.9 How the proposed rules contribute to the NEO and revenue and pricing principles

Allowing the form of control and service classification to be amended after the framework and approach stage if there are ‘unforseen circumstances’ will help to ensure that the form of control is workable. By settling the form of control and service classification to the same degree in the framework and approach, this rule change will increase the consistency of the NER.

The proposed rule changes regarding NSP submissions on their own proposals will have the effect of requiring NSPs to submit full and more complete proposals in accordance with the NER. The AER will have access to regulatory proposals as intended under the NER. Similarly, other stakeholders will have a proper opportunity to make effective submissions on NSPs’ proposals. Therefore, the certainty and transparency of the regulatory process (and contents of regulatory proposals) will increase. Being able to consider more effective stakeholder submissions will make the AER’s determinations more responsive to issues stakeholders raise.

The proposed rules will promote efficient investment, and efficient operation and use of, electricity services for the long term interests of consumers of electricity by:

- increasing certainty and transparency in the regulatory process
- increasing the workability of the AER’s form of control mechanisms and schemes
- increasing the effectiveness of the reopener and pass through mechanisms
- removing the NER’s requirement for consultation on schemes in the AER’s framework and approach, which would eliminate an unnecessary regulatory burden on DNSPs and the AER
- striking an appropriate balance between quick decision making and ensuring appropriate consideration and consultation is provide in respect of the WACC reviews and the assessment of pass through events, contingent projects and capex reopeners.

By increasing the administrative efficiency of the regulatory decision marking process the proposed rules will contribute to the promotion of the National Electricity Objective.

8.10 Expected costs and benefits and the potential impacts on those affected

The benefits of the proposed rules will be:

- to increase in the investment certainty over the service classifications and control mechanisms by changing the status of these positions the framework and approach paper
- to encourage NSPs to submit fuller and more complete proposals to ensure a more rigorous assessment by the AER and other stakeholders
- to provide consistency in the treatment of confidential information—regardless of whether it is provided by NSPs or other stakeholders
- to create a better balance between quick decision making and thorough assessment and consultation processes in respect of the WACC review, and assessments of pass through events, contingent projects and capex reopeners.

Any costs arising from proposed rule changes, if any, would be expected to be minimal.

9 Transitional arrangements

9.1 Introduction

The AER considers that if the proposed rule changes are implemented, they should apply to the next round of distribution determinations in NSW and the ACT and transmission determinations in NSW and Tasmania.

This section discusses how the proposed rules impact on:

- the framework and approach process in the lead up to the next NSW and ACT distribution determinations
- the connection between the next sector-wide WACC review and its applicability to the next NSW and ACT distribution determinations and NSW and Tasmanian transmission determinations
- the determination of the opening regulatory asset base (RAB) in each of the next transmission and distribution determinations.

The AER proposes transitional arrangements with respect to the last two matters.

9.2 Framework and approach process—Next NSW / ACT distribution determinations

The next framework and approach process for the NSW and the ACT distribution determinations will commence on or before 1 July 2012. It is unlikely that the proposed rule changes discussed in section 8.4 to the framework and approach provisions, if implemented, will be in place at that time.

The AER considers that the framework and approach provisions in the current rules should apply for the purposes for the NSW and ACT 2014 distribution determinations. The AER sees no significant detriment to the NSW and ACT DNSPs arising from this. The NSW and ACT DNSPs have not been subject to a framework and approach process as part of their current distribution determinations.

Given that the NSW and ACT DNSPs have not had the full national incentive schemes applied to them in the current regulatory control period, the current framework and approach provisions on scheme application may be useful to the NSW and ACT DNSPs for their transition to the national arrangements. This will occur under the current rules and no transitional arrangements are required.

9.3 Cost of capital calculation—Next NSW / TAS transmission and NSW / ACT distribution determinations

Under the current and proposed rules, a WACC review only applies to determinations where the initial proposal is submitted after completion of the WACC review.

The next WACC review is scheduled to be completed by 31 March 2014. The AER anticipates that any rule changes considered by the AEMC would be in place by early

2013, enabling the next WACC review to be completed according to current timing expectations, assuming approximately 12 months to complete a WACC review. However, this would result in a transitional issue for the DNSPs operating in NSW and the ACT as well as TransGrid and Transend. While the new cost of capital rule provisions would be in place sufficiently prior to the commencement of their regulatory determination processes, any WACC review outcomes would not be finalised until approximately one month prior to their final decisions.

Similar transitional issues arose for the NSW/ACT DNSPs where the MCE was consulting on the current chapter 6. In relation to the cost of capital provisions, MCE SCO noted:

- the exposure draft of the initial distribution rules did not set out previously adopted parameters, as per the current rules in chapter 6A
- it was more appropriate for the AER to consider the validity of values for distribution parameters as part of its WACC review which was to be completed by 1 July 2009
- parameters adopted in chapter 6A were proposed to be applied as a transitional measure for the NSW/ACT DNSPs.[175]

In response to stakeholder support for this proposal, the MCE considered:

> …the transmission parameters appropriate to apply to the businesses for the reset given that the AER will not have time to do a thorough review of the issues and set out its statement of regulatory intent. The adoption of the parameters will allow the AER and stakeholders to focus on the other areas of the framework given the limited time to conduct the determination.[176]

In relation to the NSW/ACT DNSPs, TransGrid and Transend, the AER considers it would be preferable to provide certainty on the WACC parameters to apply for these resets prior to commencement of their reviews. Subject to any practical limitations, if the proposed rules are implemented, all networks should be treated equally in order to ensure the benefits of this framework are consistently applied across all jurisdictions.

Given this, the AER considered a range of options to manage the implementation of the proposed WACC framework, including preserving various elements of the current framework and the timing of the next WACC review. Of the options identified, the AER is considers that a number of transitional arrangements should be in place if the proposed rules are implemented. These transitional arrangements will also ensure that the WACC parameters determined during the 2014 WACC review are applied to for the purposes of the distribution and transmission determinations for the NSW/ACT DNSPs, TransGrid and Transend.

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175 MCE SCO, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution Explanatory Material*, April 2007, pp. 44–45.

176 MCE SCO, *Response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing*, p. 85.

This enables all networks to be treated equally under the new rule framework, and involves little loss in certainty from the status quo. Specifically, in relation to the NSW/ACT DNSPs, given their distribution determination processes and the WACC review will run concurrently , the findings of the 2014 WACC review would be consistent with the AER's consideration of any persuasive evidence in the distribution determinations under the current rules. In relation to the transmission determinations for TransGrid and Transend, this would also avoid the outcome under the current rules that the AER would determine a new set of parameters in mid 2014, yet be bound to apply those determined in 2009.

The AER has also proposed rules which ensure the completeness and compliance of regulatory proposals with WACC review outcomes to recognise that, primarily because of the role of the risk free rate parameter (and need to determine the averaging period shortly after initial proposals are submitted) the initial regulatory and revenue proposals of these NSPs would reflect the parameters in the 2009 SORI, but be ultimately determined at the conclusion of the 2014 WACC review.

Table 9.1 Summary of proposed rule change: transitional arrangements for the cost of capital

No.	Current rule(s)	Proposed rule(s)	Remarks
[11.1] [11.4] [11.5]	–	11.43.1 11.43.4 11.43.5	Transitional arrangements to: – provide that the clause 6.5.4(f) and 6A.6.2(h) do not apply, and that the AER is to apply the statement on the cost of capital, – provide that a building block proposal or revenue proposal must include a period for the purposes of calculating the nominal risk free rate for, the NSW and the ACT distribution determinations, the NSW, the ACT and Tasmanian transmission determinations for the regulatory control period commencing on 1 July 2015.

Note: This table is a summary, the complete set of proposed rule changes are set out at Tables 4.1 in Part C.

9.4 RAB roll forward mechanism—Next transmission and distribution determinations in all jurisdictions

Sections 6.4, 6.5, 6.6, and 6.7 outlines the proposed rules to the RAB roll-forward mechanism.

Changes to the incentive framework can only influence future investment decisions, not past ones, and the AER recognises the importance of not changing 'the rules of the game' once the regulatory control period has commenced in order to promote investment certainty.

Accordingly, the AER does not consider that these proposed rules should be applied in rolling forward the RAB over the current regulatory control period in order to establish the opening RAB in the next transmission and distribution determinations. Instead, for each jurisdiction, the proposed rules should only apply to the RAB roll forward mechanism in establishing the opening RAB for the regulatory control period after next.

Table 9.2 Summary of proposed rule change: transitional arrangements for the roll forward of the regulatory asset base

No.	Current rule(s)	Proposed rule(s)	Remarks
[11.1] [11.2] [11.3]	–	11.43.1 11.43.2 11.43.3	Transitional arrangements to provide that the proposed changes to clause S6A.2.1(f) and S6.2.1(e) do not apply to for the next set of transmission determinations and distribution determinations, respectively.

Note: This table is a summary, the complete set of proposed rule changes are set out at Table 4.1 in Part C.