



Economic Regulation of Network Service Providers

How do the Rules constrain the AER?

May 2012

Summary

The purpose of this paper is to explain how the National Electricity Rules (rules) constrain the AER's ability to determine an estimate of efficient costs.

The restrictions arise from limitations on the AER's ability to depart from the proposal and to substitute its own estimate of efficient cost, in the face of a proposal that does not reasonably reflect the expenditure criteria. In effect, whether under Chapter 6 or Chapter 6A, the AER's substitute of efficient cost is limited to deviations from the proposal that were found to not be reasonably reflective of efficient cost.

The availability of review by the Tribunal acts as a further check on the AER's exercise of judgement.

The rules can be amended without undermining the policy intent of the original design. Indeed, clarification is required in order to give effect to the original policy intent. NSPs have repeatedly suggested that the AER already has the power to make decisions in the way that we seek. We contend that this is not so. Given these conflicting interpretations it would be beneficial to amend the decision making framework to resolve the ambiguity. The AER's proposed changes to the rules are limited in scope. They are designed to relax the most difficult features of the current regime without moving away from a guided discretion model.

This paper:

- identifies the relevant provisions of the rules
- discusses how these provisions combine with other elements of the regulatory framework in a manner that limits the AER's ability to protect the long term interests of customers
- explains why the proposed changes to the rules are extremely unlikely to result in an increase in the risk of underinvestment.

Table of contents

1	Relevant provisions of the rules.....	2
2	How the rules limit the AER’s discretion	5
	2.1 Interaction with prescribed timetables	6
	2.2 Interaction with limited merits review	7
	2.3 Gap between theory and practice	7
3	Consequences of the current rules framework.....	9
	3.1 Greater than usual incentives to over-forecast	9
	3.2 Using benchmarking to determine a substitute	9
	3.3 Loss of flexibility	10
4	Limited nature of AER’s rule change proposal	11
	Attachment 1 Expenditure objectives, factors and criteria.....	12

1 Relevant provisions of the rules

This chapter provides details of the relevant provisions that, when read together, have the effect of limiting the AER's substitute of efficient cost to deviations from the NSP's proposal.

The AER agrees with Professor Yarrow that the rules framework has been designed to mitigate the risk of under-investment caused by regulatory opportunism. To mitigate the risk of under-investment, the rules establish a "propose-respond" model, whereby the AER may only deviate from the NSP's proposal if it is satisfied that the NSP's forecast of required expenditure does not reasonably reflect the efficient costs of a prudent operator.¹

The key features of the propose-respond model are:

1. a NSP submits a revenue or regulatory proposal, which includes a proposed expenditure forecast, which the AER considers²
2. the AER must assess and determine whether it is satisfied the proposed expenditure forecast reasonably reflects the expenditure criteria, namely, the costs of a prudent operator in the circumstances of the relevant TNSP, taking into account among other things, the NSP's proposed expenditure forecast³
3. if the AER is so satisfied, it must accept the NSP's proposed expenditure forecast
4. (Chapter 6 only) if the AER is not so satisfied, it must not accept (or reject) the NSP's proposed expenditure forecast and determine a substitute forecast that starts from the NSP's proposed expenditure forecast and amends it to the extent necessary to comply with the rules
5. the AER must publish a draft decision that explains whether and why it is satisfied or not, and if it is not so satisfied, includes details of the changes required or matters to be addressed before AER will approve it and the basis and rationale of its decision, including details of methodologies and assumptions^{4, 5}
6. the NSP is entitled to submit a revised revenue or regulatory proposal, that includes a revised proposed expenditure forecast that addresses the matters to be addressed as identified by the AER in the draft decision
7. the AER must assess and determine whether it is satisfied the revised proposed expenditure forecast reasonably reflects the expenditure criteria, namely, the costs of a prudent operator in the circumstances of the relevant TNSP, taking into account among other things, the NSP's proposed expenditure forecast, repeating steps 3 to 5 above (substituting a draft decision for a final decision).

Under either Chapter 6 or Chapter 6A, the draft decision can only represent a variation from the NSP's revenue proposal. As explained in section 0 of this paper, the draft decision sets the basis for the NSP's revised revenue proposal and the AER's final decision.

Figure 1.1 (page 3) and Figure 1.2 (page 4) summarise this process. Attachment 1 sets out the expenditure objectives, criteria and factors in full.

¹ NER 6A.6.6(c) & 6A.6.7(c).

² NER 6A.6.6(a), 6A.6.7(a), 6A.6.6(e)(1) & 6A.6.7(e)(1).

³ NER 6A.14.1(2)(ii) & 6A.14.1(3)(ii).

⁴ NER 6A.12.1(c). Chapter 6 does not explicitly require the draft decision to include details of the changes required or matters to be addressed before AER will approve the DNSP's proposal.

⁵ NER 6A.14.2

Figure 1.1 Determining forecast expenditure under Chapter 6A (transmission)

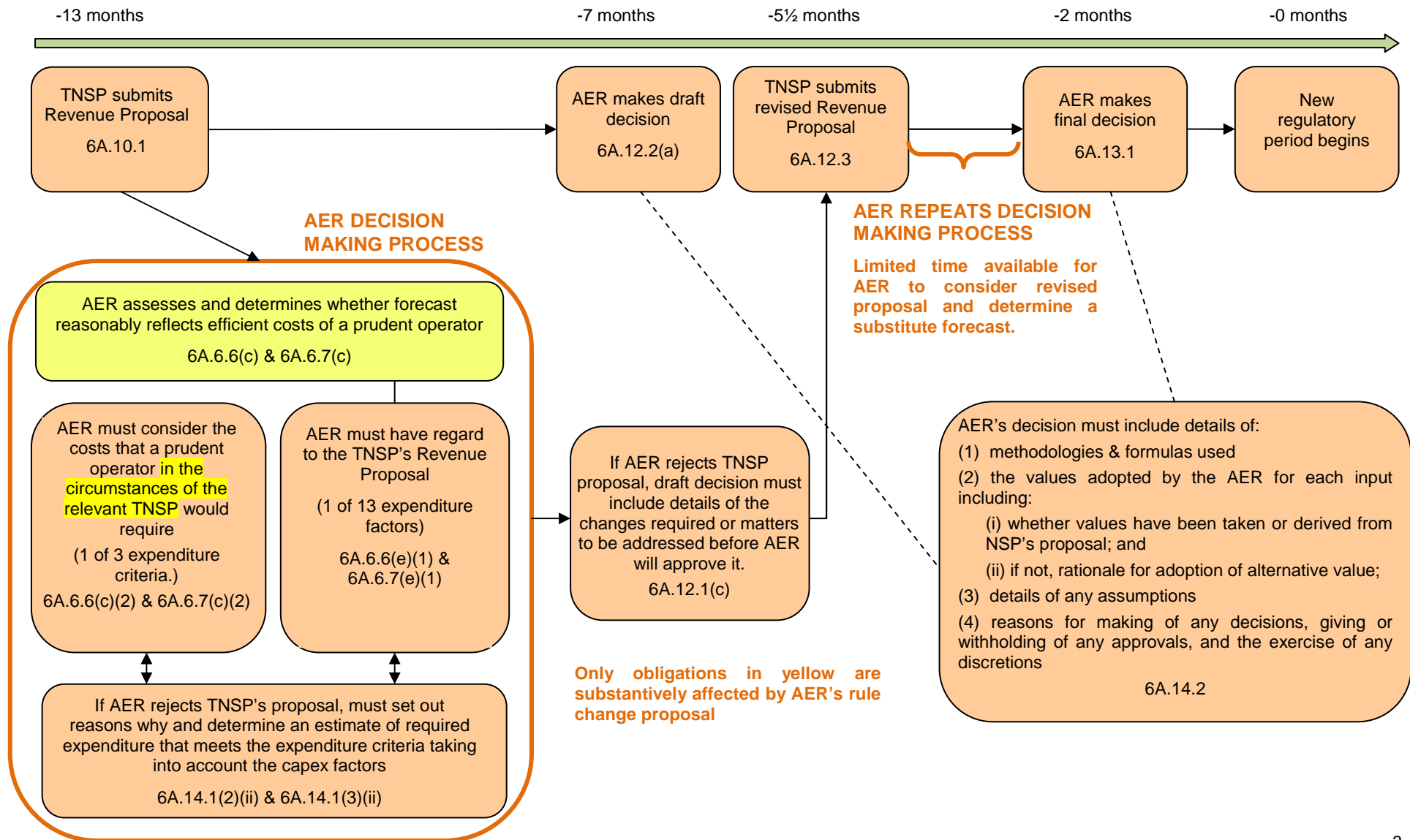


Figure 1.2 Determining forecast expenditure under Chapter 6 (distribution)

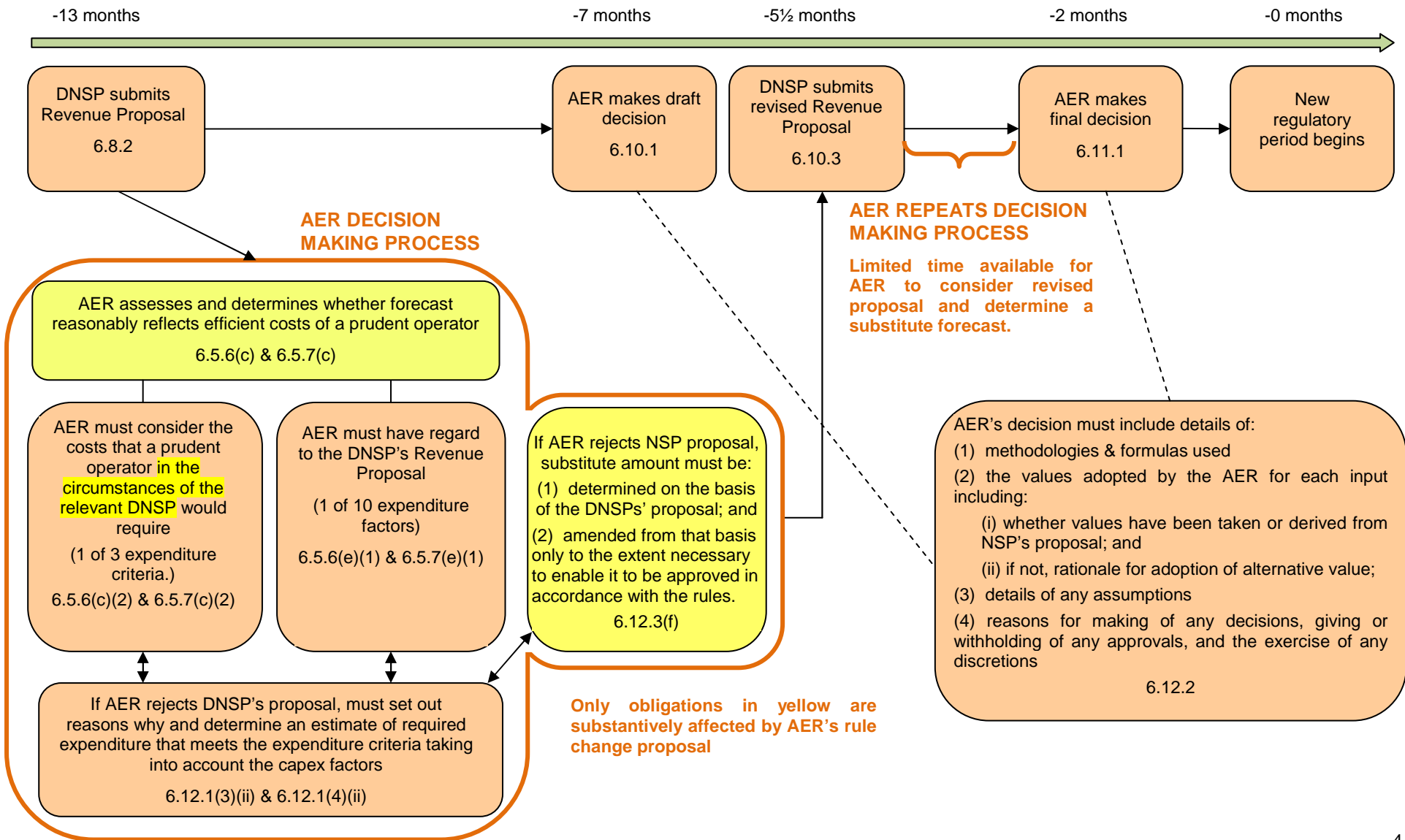


Figure 1.1 and 1.2 show how the AER must form a view on forecast opex and capex in accordance with number of rules, each of which is potentially reviewable. The timeframes associated with the reset process are tight, particularly in the lead up to the final decision.

The AER described the process for setting required expenditure in detail in its submission to the AEMC's Consultation Paper.

The AER's rule change proposal does not constitute a move away from a guided discretion model. As shown in Figure 1.1 and 1.2, the proposed changes affect only a limited proportion of the relevant rules. Most features of the guided discretion model would remain (although they may be moved or reworded to reflect the removal of the propose-respond model).

2 How the rules limit the AER's discretion

Even if the AER is not satisfied the proposed total forecast reasonably reflects the required expenditure, in developing a substitute the AER must always begin with the business' proposal and set out the changes to that proposal in the draft decision. In practice, this unduly ties the regulator to the network businesses' proposal in the determination of the total forecast that 'reasonably reflects' the required expenditure. While a proper consideration of the proposal from the business should always form part of the regulator's consideration of the required expenditure (and the AER is required to do this under its rule change proposal), the current rules go further than this. The rules require the AER to determine a forecast of required expenditure which is a constrained variation of the proposal put forward by the NSP.⁶

In Chapter 6, the AER is explicitly restricted to only amending amounts and values that are constituent decisions on the basis of the regulatory proposal and only to the extent necessary to enable it to be approved under the rules, including forecasts of capital and operating expenditure.⁷ This applies to both the draft and final decisions.

In Chapter 6A, the AER's draft decision must include details of what changes would be required to the NSP's capital and operating forecasts in order for them to be approved.⁸ In turn, this requires the AER to address the revenue proposal on its own terms to highlight the areas where changes are required to enable it to be approved.

Accordingly, the substitute amount determined by the AER in the draft decision will be the forecast proposed by the network business adjusted for any specific forecast costs identified that require amendment before they could be approved in the final decision. The detailed, technical regulatory determination process that has prevailed under the current rules is the direct product of the framework which requires the AER to forensically address the NSPs' proposal in order to determine a substitute forecast.

2.1 Interaction with prescribed timetable

As shown in Figures 1.1 and 1.2, in both Chapter 6 and Chapter 6A the AER generally has around 3¹/₂ months to

1. examine the material submitted in the NSP's revised proposal,
2. form a view on whether the revised forecasts reasonably reflect efficient costs,
3. if the AER is not so satisfied, determine a substitute amount and
4. draft the final decision.

The AER does not know whether it will be necessary to determine a substitute amount as part of step 3 until it has completed steps 1 and 2. This compressed timetable makes it difficult for

⁶ Alternatively the rules require the AER to accept the NSP's proposal if it is satisfied that the proposal reasonably reflects efficient costs. NER 6A.6.7(c), 6A.6.6(c), 6.5.6(c) and 6.5.7(c).

⁷ NER 6.12.3(f).

⁸ NER 6A.12.1(c).

the AER to carry out new analysis which is sufficiently detailed to take into account each of the issues raised by the NSP. In most cases, therefore, at this stage in the process there is very little opportunity for the AER to undertake rigorous, independent and significant new analysis in order to determine a substitute forecast.

Further, to the extent the AER's potential substitute forecasts for the final decision are not based on the original proposal or the analysis and approach reflected in the draft decision, the network business (and other stakeholders) would have had no notice of AER's substitute forecasts. As the businesses are entitled to procedural fairness, often the only practical option for the AER is to keep its final determination within the bounds of the draft decision and revised proposal. The time between the closing of submissions and the final AER decision is insufficient to allow for further consultation except in regards to limited issues.

2.2 Interaction with limited merits review

Professor Yarrow's preliminary paper observes that "the greater the discretion at the decision stage the greater tends to be the ex post supervision (by courts, tribunals etc)". However, the Australian regulatory model involves close supervision of the AER at both the decision-making stage and the ex post stage.

The close ex post supervision that applies to the AER's decisions, from both judicial and merits review, significantly diminishes the risk that the NSPs would not be afforded a reasonable opportunity to recover at least their efficient costs, as required by the Law. Accordingly, there is scope to relax the level of supervision at the decision making stage by making it clear that the AER is empowered to make a balanced decision on the level of efficient costs.

2.3 Gap between theory and practice

There is a very real practical difference between the day to day exercise of regulatory functions and powers (and in particular, overcoming any information asymmetries) and how those same functions and powers may be specified in the rules.

Even regulators which have broad statutory powers find themselves constrained in practice. For instance, the AER notes that the AEMC made the following observations concerning Ofgem's use of its powers:

while Ofgem does appear to have much broader discretion than the AER, in practice the use of this discretion is heavily constrained by the ability of the NSPs to reject price control proposals and initiate a wide ranging appeal process... It appears to the Commission that there may not in fact be such a significant difference between the policy intent of the AEMC in developing the Chapter 6A rules for transmission and the actual practice of Ofgem.⁹

The AEMC appears to be of the view that changes to the rules are unnecessary because other regulators have tended to exercise their broader powers in a manner similar to that envisaged by the AEMC in its 2006 decision. However, the construction of the rules in the

⁹ AEMC directions paper, pg 27-28.

Australian context prevents the type of broad inquiry anticipated by the AEMC in 2006 and observed in the decisions of other regulators.

Indeed, if the policy intent of 2006 is actually to be realised and NSPs are genuinely to have incentives to put forward their most accurate forecast of efficient cost, the existence of regulatory discretion is a necessary precursor. In the absence of the ability of the regulator to meaningfully substitute its own estimate of efficient cost, there will be very limited incentive on the business to propose their true efficient cost forecasts, as they know that the regulator is bound to variations from their proposal.

3 Consequences of current rules framework

The constraints on regulatory discretion gives rise to further adverse consequences including greater than usual incentives on NSPs to over-forecast, problems with using benchmarking in a determinative sense and a loss of flexibility in the regulatory framework.

3.1 Greater than usual incentives to over-forecast

A consequence of the current rules framework relates to the characteristics of the cost information submitted by NSPs. The incentives to submit inflated forecasts are greater under the current rules than under a traditional regulatory regime because the current rules make the AER more dependent on information provided by NSPs. This dependence arises because the AER is required to show how a proposal does not reasonably reflect efficient costs, with the primary sources of evidence for this exercise lying with the NSP. The current regime can be contrasted with other regulatory regimes - for instance, the regime that applies in the UK - where it is incumbent upon the NSP to "sell" its proposal to the regulator. In these regimes the regulator may ignore information that is demonstrably poor quality and the onus is upon the NSP to provide clear information on its efficient costs that would make it more difficult for the regulator to set aside.

Further, there is no effective adverse consequence in the event that the AER rejects a proposal insofar as the AER is limited in the extent to which it can modify the NSPs original proposal. The regime thus operates to encourage NSPs to propose a highly conservative forecast (ie that is overly risk averse without adequate justification) on the basis that if rejected, the amount by which it will be reduced is likely to be relatively small, than propose a more realistic but more modest proposal that is more likely to be accepted. In a tactical sense, it is better for the NSP to lodge a highly conservative forecast that is rejected and reduced by a small amount than to lodge a modest proposal that is accepted.

Accordingly, the propose-respond model provides strong incentives on NSPs to submit regulatory proposals that are based on a conservative engineering cost build-up that are optimised for the interests of the NSP in maximising its allowances. The NSP has an incentive to propose forecasts made up of a conservative estimate (e.g. in terms of demand) on top of conservative estimate (e.g. in terms of cost), which together combine to form an overstated forecast. The conservative forecast proposed by the NSP is likely to include individual projects which would not be considered necessary during the relevant regulatory period if less conservative forecasts were adopted. At the forum of 2 April 2012, the NSPs characterised these projects as 'nice to haves' rather than 'must haves'.

3.2 Using benchmarking to determine a substitute

While the AER may have used various analytical techniques to improve its understanding of NSPs' costs, there is an important distinction to be made between conducting analysis on the one hand and relying on this analysis to determine allowances on the other. The AER can readily apply benchmarks as an informative tool when deciding whether it is satisfied that the NSPs' forecast reasonably reflects efficient costs. However, the AER has encountered a number of practical difficulties when seeking to use the results of benchmarking analysis to determine a substitute forecast under Chapters 6 and 6A. These difficulties arise as a result of a combination of:

- the requirement to determine substitute estimates on and from the basis of the NSP's proposal
- the ambiguity surrounding the obligation to consider the circumstances of the relevant NSPs
- timing issues which mean that by the time that the AER and its advisors are satisfied that the NSPs' forecast should be amended, there is limited time available to conduct the analysis to determine a substitute amount (see Figure 1.1).

These problems are discussed in more detail in section 1.2.1 of the AER's submission to the AEMC's Directions Paper. See also the AER's submission to the PC's benchmarking inquiry.

3.3 Loss of flexibility

Finally, the prescriptive rules framework has adverse consequences in terms of a loss of flexibility. The rigid arrangements that apply in Australia have failed to keep pace with international developments. While the AER would like to explore new models such as menu regulation and further involvement of consumers in the regulatory process, we note that these mechanisms would require a fundamental shift in the relationship between the AER and NSPs since they implicitly acknowledge that the reset is a negotiation. Our highly structured process, with its major role for merits review, leaves no scope for negotiation.

4 Limited nature of AER's rule change proposal

Concerns that the AER's proposal might lead to underinvestment are unfounded. The AER does not seek unguided discretion. Our discretion would be constrained by a range of provisions:

- The Law requires that the AER is to take into account the revenue and pricing principles, which includes ensuring that a NSP should be provided with a reasonable opportunity to recover at least efficient costs the operator incurs in providing services and complying with regulatory obligations, when it exercises a discretion in making those parts of a distribution determination or a transmission determination relating to direct control network services.¹⁰ The reference to 'at least efficient cost' reflects the accepted principle in regulatory economics that, given the consequences of a supply failure, a small under-investment in infrastructure has a greater economic cost than a small over-investment. In order for the AER to properly take this into account, it is necessary for the AER to consider the NSP's costs. By requiring the AER to allow "at least efficient costs", the Law makes clear that if in doubt, the AER should err in favour of the businesses.
- The Law also requires that the AER is to ensure a NSP is informed of the material issues under consideration by the AER and given a reasonable opportunity to make submissions in respect of a distribution or transmission determination before it is made.¹¹
- The expenditure objectives in the rules, which the AER proposal does not amend.¹²
- The AER proposes to retain the majority of the features of the guided discretion model currently set out in the rules, including the requirement to consider the NSPs' proposal, the requirement to explain what changes are required in order for the AER to approve the NSPs' proposal and the requirement for the AER to set out the basis and rationale for its decisions (see Figure 1.1).

The adoption of the propose-respond model was motivated in part by a desire to ensure that the NSPs' proposal is central to the regulatory process. It was seen as a way of reducing the risk of the regulator not allowing sufficient investment through not understanding the circumstances of the business properly. However, this approach failed to recognise and appropriately balance the risk of the NSP proposing an inflated forecast. While the NSPs' proposal should be a significant part of the AER's deliberations, it is important that it not inappropriately constrain the AER's decision making.

The AER's rule change proposal does not attempt to move away from a guided discretion model, it just tries to make the current model work more effectively.

¹⁰ NEL, ss 7A(2) and 16(1)(b).

¹¹ NEL, s 16(2).

¹² NER, 6.5.6(a), 6.5.7(a), 6A.6.6(a) and 6A.6.7(a).

Attachment 1 Expenditure objectives, factors and criteria

Capex and opex objectives [NER 6A.6.7(a) & 6A.6.6(a)]

A Revenue Proposal must include the total forecast expenditure for the relevant regulatory control period which the TNSP considers is required in order to:

1. meet the expected demand for prescribed transmission services over that period;
2. comply with all applicable regulatory obligations or requirements associated with the provision of prescribed transmission services;
3. maintain the quality, reliability and security of supply of prescribed transmission services; and
4. maintain the reliability, safety and security of the transmission system through the supply of prescribed transmission services.

Capex and opex criteria [NER 6A.6.7(c) & 6A.6.6(c)]

Total forecast expenditure must reasonably reflect:

1. the efficient costs of achieving the operating expenditure objectives;
2. the costs that a prudent operator in the circumstances of the relevant Transmission 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.

Capex and opex factors [NER 6A.6.7(e) & 6A.6.6(e)]

The AER must have regard to:

1. the information included in or accompanying the Revenue Proposal;
2. submissions received in the course of consulting on the Revenue Proposal;
3. such analysis as is undertaken by or for the AER and is published prior to or as part of the draft decision of the AER on the Revenue Proposal under rule 6A.12 or the final decision of the AER on the Revenue Proposal under rule 6A.13 (as the case may be);
4. benchmark operating expenditure that would be incurred by an efficient Transmission Network Service Provider over the regulatory control period;
5. the actual and expected operating expenditure of the provider during any preceding regulatory control periods;
6. the relative prices of operating and capital inputs;
7. the substitution possibilities between operating and capital expenditure;

8. whether the total labour costs included in the capital and operating expenditure 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 to which the forecast of required operating expenditure of the Transmission 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. whether the forecast of required operating expenditure includes amounts relating to a project that should more appropriately be included as a contingent project under clause 6A.8.1(b);
11. the most recent NTNDP and any submissions made by AEMO, in accordance with the rules, on the forecast of the Transmission Network Service Provider's required operating expenditure.
12. the extent to which the Transmission Network Service Provider has considered and made provision for efficient and prudent non network alternatives; and
13. any relevant project assessment conclusions report required under clause 5.6.6.