

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

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

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

7.3.3 Return on debt for state-owned service providers

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

- the absence of competitive neutrality fees could not be expected to have any meaningful impact on allocative efficiency;¹³⁷
- based on EURCC calculations, it was difficult to argue that taxpayers would be subsidising electricity users in the absence of competitive neutrality fees;¹³⁸
- income taxes should be counted as part of the return on equity for government-owned service providers;¹³⁹
- there is no meaningful level of competition between government-owned service providers and therefore the rationale for the application of the Competition Principles Agreement to these service providers is not valid; and¹⁴⁰
- just as the AEMC proposes to guard against transfer pricing arrangements between related parties it should do the same for competitive neutrality fees as they are substantially the same thing.¹⁴¹

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

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

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

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

¹³⁷ Id., pp. 9-10.

¹³⁸ Id., p. 10.

¹³⁹ Id. pp. 10-11.

¹⁴⁰ Id., p.11.

¹⁴¹ Ibid.

7.4 Analysis

7.4.1 Options to use different methodologies

Proposal for return on debt methodology by the service provider

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

Factors to consider as part of assessing methodologies

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

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

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

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

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

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

¹⁴⁴ *Id.*, p. 7.

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

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

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

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

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

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

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

¹⁴⁵ Id., p. 21

¹⁴⁶ Ibid.

7.4.2 Specification of benchmark characteristics

The appropriate benchmark

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

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

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

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

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

7.4.3 Return on debt for state-owned service providers

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

State-owned service providers do not access debt capital markets directly, but rather, their debt is managed by the respective state government's treasury corporations through the issuance of government bonds, which is taxpayer backed bonds, directly in the market. It is the treasury corporations who have access to lower debt funding costs due to the government's higher credit ratings compared to private sector businesses. Governments can generally borrow at lower rates than private firms due to governments' ability to service the debt through taxation. The treasury corporations

and state treasurers lend these funds to the state-owned service providers at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating. The stand-alone credit rating is the measure of the businesses' credit worthiness independent of explicit or implicit financial support from the state governments.

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

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

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

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

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

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

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

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

Allocative inefficiency

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

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

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

¹⁴⁸ Ibid.

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

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

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

Taxpayers subsidising users

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

Taxes counted as return on equity

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

Competition or monopoly

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

Regulatory authority

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

7.5 Guidance on final rule

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

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

¹⁵¹ Id., p. 11.

¹⁵² Ibid.

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

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

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

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

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

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

propose an alternative approach to that proposed by the regulator in the guidelines, but the service provider will need to explain why its proposed approach is better than the approach proposed by the regulator in the guidelines.

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

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

8 Capex and opex allowances and factors

Summary

- The Commission has analysed evidence provided to it of the drivers of higher prices, which indicate that both the rate of return and expenditure allowances have been significant factors. However, it is not possible to discern if they have been inefficient, or if there is a problem with the NER.
- The approach to expenditure allowances was set by the AEMC in Chapter 6A in 2006. It includes that the NSP's forecast should be the starting point for the AER's analysis, but the AER is free to use a range of analytical techniques and should consider all material and submissions before it.
- Analysis confirms that the practices of the AER conform to good regulatory practice when compared with other regulators in Australia and overseas, and the Commission's view is that the NER reflects these practices.
- In general, the existing provisions of the NER provide the AER with appropriate discretion to set capex and opex allowances at an efficient level, assuming it has adequate information and uses appropriate analytical techniques.
- However, there are some areas for improvement to clarify the approach and remove ambiguities, specifically in relation to the AER's discretion and benchmarking.
- Benchmarking can play an important role in assessing the efficiency of a NSP's capex and opex forecasts. Any use of benchmarking should take into account differences in the operating environments of the different NSPs. The AER should be required to undertake annual benchmarking of NSPs.
- It is appropriate that the approach for assessing expenditure forecasts be set out in guidelines. NSPs will be required to submit complying information with their regulatory proposal. Early engagement on these models with the NSP's is beneficial and should be included as part of the framework and approach paper.

Difference between draft rule and final rule

- In the final rule, the AER's discretion has been further clarified by the removal of general restrictions on the AER's discretion, consistent with the Commission's overall approach in this rule change.
- The obligation on a NSP to submit forecast expenditure methodologies as required by the AER has been adjusted. Instead the NSP may provide assessment information required by the AER separate to its regulatory proposal.

8.1 Introduction

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

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

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

The remainder of this chapter is structured as follows:

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

8.2 Directions paper and draft rule determination

The draft rule determination proposed amendments in three areas:

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

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

¹⁵⁴ *Id.*, p. 6.

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

8.2.1 Clarifying the discretion of the regulator

Background analysis

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

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

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

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

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

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

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

Brattle did not identify any fundamental differences between the approach of the AER and the practices of regulators in the other jurisdictions. It noted that while the level of prescription in the rules differs among jurisdictions, the regulators operating under such rules do not undertake less analysis nor do they seem to be restricted in the choice of tools for the purposes of such analysis.¹⁵⁷ Rules may affect the weight put on the results of different analysis, but Brattle is not able to determine this conclusively.¹⁵⁸ On the basis of Brattle's conclusion, the Commission took the view that the approach to expenditure allowances in Chapter 6A, which generally reflects the AER's practices, remains fairly consistent with good practice as reflected in the practices of the other regulators examined by Brattle.

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

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

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

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

¹⁵⁶ The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 74. This paragraph also explains why each of the four overseas jurisdictions was chosen.

¹⁵⁷ Id., paragraphs 13, 30 and 31.

¹⁵⁸ Id., paragraph 33.

¹⁵⁹ Id., paragraph 44.

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

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

Proposed amendments

The Commission confirmed that the NER is drafted appropriately in many areas. With the exception of benchmarking, the capex and opex criteria remain valid. For example, the obligation to accept a reasonable proposal should reflect the AER's current practice. There is no reference to a reasonable range, which is appropriate.¹⁶⁰ The AER, whenever it determines a substitute for a NSP's proposal, is not constrained by the capex and opex criteria from choosing the best substitute it can determine.

In terms of whether it is appropriate for the process to start with the NSP submitting a proposal to the AER, Brattle has shown that this is accepted practice in most of the jurisdictions it surveyed.¹⁶¹ In jurisdictions where this did not occur, the regulator tended to be reviewing a large number of smaller businesses, such as in New Zealand. Of much more import is whether the AER has the necessary tools to scrutinise the NSP's proposal.

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

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

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

¹⁶⁰ Id, paragraph 42.

¹⁶¹ Id., paragraph 14.

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

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

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

⁹⁶ Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

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

The AER proposed that the criterion relating to demand forecasts and cost inputs¹⁶⁵ was less important than the first two criteria and should be moved to the capex and opex factors. The view was taken in the draft rule determination that it would position demand forecasts and cost inputs as objectives rather than key elements of expenditure allowances that are relevant in a range of ways. The Commission therefore remained of the view that this criterion should remain where it is.

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

Other issues

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

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

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

¹⁶⁶ Id., paragraphs 21, 35 and 41.

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

8.2.2 Annual benchmarking reports and engagement on expenditure models

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

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

Each of these is discussed below.

Annual benchmarking reports

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

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

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

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

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

⁹⁸ Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

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

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

Engagement on the expenditure model

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

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

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

¹⁶⁹ The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 44.

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

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

¹⁷² AER, Directions Paper submission, 2 May 2012, p. 12.

decided that there should be no restriction on a NSP also including expenditure forecasts generated using other methodologies in its regulatory proposal.

8.2.3 Capex and opex factors

The AER proposed a number of discrete changes to the capex and opex factors. Below is a summary of the Commission's proposal in relation to each.

Process-related changes

The Commission maintained its position in the draft rule determination from the directions paper to move the process-related changes from the capex/opex factors to the "procedural" provisions further back in Chapters 6 and 6A.¹⁷³ These provisions have a different character from the other factors in that they deal with the materials presented to, or obtained by, the AER in the course of the regulatory process, as opposed to facts or data. As such, they sit better with the other procedural provisions, such as clause 6.11.1.

The ENA raised a concern at law that the AER's proposed shift from "have regard to" wording to "consider" wording in respect of two of these factors will affect the overall decision-making process.¹⁷⁴ To accommodate this, the draft rule adopted the "have regard to" wording for all three factors.

The Commission further considered the views it presented in the directions paper regarding the requirement on the AER to consider analysis it has published.¹⁷⁵ It acknowledged the challenges in using merits review to test analysis published with a final regulatory determination, and notes that under section 16(1)(b) of the NEL the AER is required to inform NSPs of material issues under consideration, as raised in the ENA's submission.¹⁷⁶ However, the Commission maintained the position that because of the fixed time the AER has to reach a final regulatory determination there could be times when it is too difficult for the AER to consult on analysis prior to it. To balance the time constraints against the need for scrutiny of new material, the draft rule required the AER to use its best endeavours to publish analysis on which it proposes to rely, or which it proposes to refer to, prior to the making of the final regulatory determination. Further, in the event of any inconsistency between the NER and NEL, the NEL has priority over related provisions of the NER.

¹⁷³ AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 33.

¹⁷⁴ ENA, Directions Paper submission, Attachment F, 16 April 2012, p. 68.

¹⁷⁵ AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 32.

¹⁷⁶ ENA, Directions Paper submission, 16 April 2012, p. 41; ENA, Directions Paper submission, Attachment F, 16 April 2012, p. 69.

¹⁰⁰ Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

Non process-related changes

In the draft rule determination, the Commission maintained its view from the directions paper that the capex and opex factors should remain mandatory considerations. In respect of whether these factors are exhaustive, the Commission also maintained its position from the directions paper that the AER is not at present limited to the factors set out in the NEL. At the same time, however, different clauses in the NEL take an inconsistent approach to whether additional drafting was required to confirm that factors are exhaustive, and this could lead to ambiguity. To clarify this, an additional factor was added to the capex and opex factors allowing the AER to consider other factors. Since a NSP should be given the opportunity to address factors against which its forecast will be assessed, the draft rule included a requirement that the AER notify the NSP in advance of any such additional factor or factors. This reflects the AER's obligations in section 16(1)(b)(i) of the NEL.

Various other changes to the capex and opex factors were also proposed. One factor relates to the service target performance incentive scheme (STPIS) (see for example clause 6.5.6(e)(8)). The original intent behind this factor is that expenditure allowances with respect to labour costs should be sufficient to allow the NSP to respond to the incentives as part of the STPIS. The AER has suggested this factor could be broadened.¹⁷⁷ The Commission agreed with this and removed the reference to labour costs and broadened the scope of the incentive schemes covered. In addition, consequential amendments were proposed to the capex and opex factors in Chapter 6 to recognise the addition of the contingent projects regime.

It was also proposed that the factor relating to benchmarking¹⁷⁸ be expanded to refer to the annual benchmarking reports.

Finally, a factor was added that requires the AER to have regard to the extent to which NSPs have considered what consumers seek. NSPs should be engaging with consumers in preparing their regulatory proposals and should factor in the needs and concerns of consumers in determining, for example, their capex programs. What consumers want and are prepared to pay for, whether in terms of reliability or some other element, will assist in showing what is efficient. The more confident the AER can be that consumers' concerns have been taken into account, the more likely the AER could be satisfied that a proposal reflects efficient costs. A similar approach is taken in Great Britain by Ofwat in respect of water regulation.¹⁷⁹

¹⁷⁷ AER, Rule change request, Part B, 29 September 2011, p. 34.

¹⁷⁸ See for example clause 6.5.7(e)(4).

¹⁷⁹ See for example Ofwat, *Involving customers in price setting - Ofwat's customer engagement policy statement*, April 2011, p. 21.

8.3 Submissions

Submissions from consumer representative and large user groups are supportive of the changes proposed in the draft rule determination.¹⁸⁰ The AER is also strongly supportive of the changes. It states that the draft rules are a clear improvement by allowing it greater scope to reject excessive cost forecasts. However, it has raised concern over the remaining restrictions in clause 6.12.3(f) as well equivalent clauses in Chapter 6A (discussed below).¹⁸¹ Independent Pricing and Regulatory Tribunal (IPART), the Victorian Department of Primary Industries (Victorian DPI) and retailers are also supportive of the changes.¹⁸²

UE and MG support the changes to clarify the NER as well as benchmarking. However, like many of the NSPs, they do not support the changes in relation to an expenditure forecast methodology, which is also reflected in the ENA's submission.¹⁸³ The ENA also has concerns in relation to benchmarking and the amendments to clause 6.12.3(f).¹⁸⁴ Submissions on all three of these specific issues are discussed below.

8.3.1 Clarifying the discretion of the regulator

The AER supports the reasons for the amendments to clause 6.12.3(f) but states that it still restricts the AER from making overall decisions. It proposes for the clause to be deleted, as there have been no strong arguments to support the retention of the remaining restrictions. It states that without the clause it is still required under administrative law and other clauses in the NER to take into account a NSP's proposal and all relevant information.¹⁸⁵

SA Power Networks, CitiPower and Powercor submit that the clause should remain unchanged. It states that the clause is consistent with the recognition that the NSP's proposal is the most detailed and relevant evidence.¹⁸⁶ The ENA disagrees with the

¹⁸⁰ MEU, Draft Rule Determination submission, 4 October 2012, p. 20; EUAA, Draft Rule Determination submission, 3 October 2012, p. 15; Ethnic Communities' Council, Draft Rule Determination submission, 4 October 2012, p. 2; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 2; Alternative Technology Association, Draft Rule Determination, 4 October 2012, p. 8.; UnitingCare, Draft Rule Determination submission, 16 October 2012, p.15.

¹⁸¹ AER, Draft Rule Determination submission, 5 October 2012, p. 10; AER, Draft Rule Determination supplementary submission, 25 October 2012, pp. 8-9.

¹⁸² Victorian DPI, Draft Rule Determination submission, 2 November 2012, pp. 1-2; IPART, Draft Rule Determination submission, 2 October 2012, pp. 5-6; Origin Energy, Draft Rule Determination, 4 October 2012, p. 1; EnergyAustralia, Draft Rule Determination submission, 15 October 2012, p. 2.

¹⁸³ UE and MG, Draft Rule Determination submission, 4 October 2012, pp. 11-14; ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-33.

¹⁸⁴ ENA, Draft Rule Determination submission, 4 October 2012, pp. 19-21, 33-36.

¹⁸⁵ AER, Draft Rule Determination submission, 5 October 2012, pp. 10-13.

¹⁸⁶ SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p.19.

¹⁰² Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

carve out of rate of return from this clause.¹⁸⁷ This has been discussed in section 6.4.7 . The ESAA has also raised that by providing more discretion to the AER increases the risk that overall revenue is inadequate and the AER needs to carefully consider how it minimises this risk.¹⁸⁸

8.3.2 Benchmarking

UE and MG disagree with the draft amendment to remove the "individual circumstances" phrase. They state that an assessment of prudent and efficient expenditure requires consideration of the particular circumstances and that without it there is a signal that a NSP's circumstances are not relevant.¹⁸⁹ Likewise, SA Power Networks, CitiPower and Powercor disagree with the removal of the phrase, since the AER has been shown not to consider individual circumstances in cases before the Tribunal.¹⁹⁰ The ENA also disagrees with its removal stating that the phrase does not constrain benchmarking and that recognition of individual circumstances are a fundamental element for an assessment of forecasts.¹⁹¹ Grid Australia also disagrees with the removal of the phrase.¹⁹²

Grid Australia is concerned about the role of benchmarking and refers to the findings of the Total Factor Productivity Review (a form of benchmark regulation) which found that it is not appropriate to be applied to transmission.¹⁹³ Ergon Energy states that consideration should also be given to the costs of collection of additional information and that differences in networks mean it may not be possible to take into account all relevant factors. In that case, the AER should have discretion not to publish an annual report. If required to publish one, it should not be directed to have regard to the last one as there will be a lag with the data and as a result publication of such a report is likely to mislead less informed market participants.¹⁹⁴ SA Power Networks, CitiPower and Powercor have no objection to the preparation of benchmarking reports but consider further guidance useful, such as the relevant factors to consider.¹⁹⁵

The AER is supportive of the changes to benchmarking, as is Origin Energy.¹⁹⁶

¹⁸⁷ ENA, Draft Rule Determination submission, 4 October 2012, pp. 19-21.

¹⁸⁸ ESAA, Draft Rule Determination submission, 23 October 2012, p. 3.

¹⁸⁹ UE and MG, Draft Rule Determination submission, 4 October 2012, pp. 13-14.

¹⁹⁰ SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 18-19.

¹⁹¹ ENA, Draft Rule Determination submission, 4 October 2012, pp. 33-36.

¹⁹² Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 11

¹⁹³ Ibid.

¹⁹⁴ Ergon Energy, Draft Rule Determination submission, 7 October 2012, pp. 6-7.

¹⁹⁵ SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 17-19.

¹⁹⁶ AER, Draft Rule Determination submission, 5 October 2012, pp. 12-13; Origin Energy, Draft Rule Determination submission, 4 October 2012, p.1.

8.3.3 Expenditure forecast methodology

SP AusNet states that the expenditure forecast methodology conflicts with the NSP's responsibility for preparing and submitting expenditure forecasts in its regulatory proposal. Furthermore, it states that an additional methodological approach in addition to the one preferred by the NSP will result in duplication.¹⁹⁷ Jemena also does not support a standard expenditure forecast methodology. It states that it is inconsistent with current sign-off requirements and will duplicate work where a NSP still needs to provide its own best forecast and the AER must evaluate both.¹⁹⁸ The ENA provides similar reasons in its submission, it states that it would be more appropriate to require NSPs to provide an informal briefing to the AER on their approaches at the framework and approach stage. The ENA provides alternative rule amendments consistent with its recommendations.¹⁹⁹

On the contrary, SA Power Networks, CitiPower and Powercor support the proposal to establish standard forecasting approaches. They state that it should encourage forecasting issues to be discussed upfront at the framework and approach stage. However, they state that the intention that NSPs are free to submit their own forecast based on methodologies other than those in the framework and approach paper is not sufficiently clear in the drafting and should be clarified.²⁰⁰

The AER is strongly supportive of the proposal stating that it will support benchmarking and its ability to determine an efficient estimate of forecast costs.²⁰¹

8.3.4 Capex and opex factors

SA Power Networks, CitiPower and Powercor states that "any other factor" should be identified at the framework and approach stage. Such an approach would ensure appropriate consultation and allow parties other than the NSP to be aware of what they may include.²⁰² In contrast, the AER has submitted that it should be able to consider any other factor prior to the submission of a revised proposal since other relevant factors may arise during the regulatory process after the submission of a regulatory proposal.²⁰³ Energex has also suggested that the factor to refer to the annual benchmarking report refer to benchmarking material more generally, as there may be other info that may be equally relevant.²⁰⁴ The Energy Supply Association of Australia (ESAA) submitted that in relation to the factor on consumer consultation, it

¹⁹⁷ SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 3-4.

¹⁹⁸ Jemena, Draft Rule Determination submission, 4 October 2012, pp. 10-14.

¹⁹⁹ ENA, Draft Rule Determination submission, 4 October 2012, pp. 29 -33.

²⁰⁰ SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 17-18.

²⁰¹ AER, Draft Rule Determination submission, 5 October 2012, pp. 11-12.

²⁰² SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 19.

²⁰³ AER, Draft Rule Determination supplementary submission, 25 October 2012, p. 6.

²⁰⁴ Energex, Draft Rule Determination submission, 4 October 2012, p. 2.

will be important to understand how the AER will evaluate supporting evidence. It states that consumer consultation is costly and cost recovery for such activities must also be taken into account.²⁰⁵

8.4 Analysis

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

8.4.1 Clarifying the discretion of the regulator

In the draft rule determination the Commission amended clause 6.12.3(f) so it was made clear that the restrictions on the AER's discretion to make substitute decisions did not apply in respect of capex or opex allowances (or, as discussed in chapter 6, rate of return framework). This was determined on the basis that there is no equivalent clause in Chapter 6A and that the AER's interpretation of the clause was imposing a greater constraint on it than intended. Further, the Brattle report identified the wording of the clause as unhelpful, in particular if it were to be interpreted to rule out "top down" adjustments.²⁰⁶

Although the AER proposed the removal of the entire clause (as well as the equivalent clause in Chapter 6A), the Commission took the view that the ambiguity which was highlighted by the AER was primarily in relation to capex and opex allowances (chapter 6 includes a discussion regarding the rate of return issue with regard to this clause). The view was taken that an amendment similar to that which is contained in Chapter 6A, which excludes capex and opex from the same limitation, would clarify the intention of the clause and address the AER's concerns.

However, the AER's submission to the draft rule determination states that, despite the carve out of capex and opex allowances, restrictions on the remaining provisions may prevent it from making overall decisions in expenditure allowances. As a result, the AER maintains that the clauses should be deleted such that it can make overall decisions that are aimed at satisfying the NEO.²⁰⁷ It gives the following reasons:

1. Other decisions affect the capex and opex allowances, such as depreciation, cost inputs and demand forecasts which are subject to the restrictions. As components of the capex and opex allowances, to the extent they remain subject to restrictions, the AER remains restricted in determining the total values. At a minimum, the AER states it creates confusion and uncertainty around how these provisions may operate within a total determination decision.

²⁰⁵ ESAA, Draft Rule Determination submission, 23 October 2012, p. 3.

²⁰⁶ The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 38.

²⁰⁷ AER, Draft Rule Determination submission, 5 October 2012, p. 10; AER, Draft Rule Determination supplementary submission, 25 October 2012, pp. 8-9.

2. Without capex, opex and rate of return allowances being subject to the clause it is unclear why the remaining restrictions are appropriate. The AER considers that no strong arguments have been put forward to support the retention of the remaining restrictions.
3. There is no clear rationale for the operation of the clauses once it is accepted that capex, opex and rate of return decisions should not be subject to these restrictions.²⁰⁸

The Commission accepts that there are many interrelationships between various inputs and values. For example, clause 6.12.1(10) which relates to any other appropriate amounts, values or inputs could be relevant to components of overall capex decisions such as unit rates or escalation factors. It would be difficult to specify those relationships within the framework of the NER with sufficient clarity to facilitate the intention of the carve out. As a result, relaxing the constraint on the overall capex decision would be inconsistent with leaving the constraints on potential inputs to that decision. Further, the constraint would still remain on overall revenue (clause 6.12.1(2)) which may potentially constrain the extent that capex, as an input to that decision, could be amended.

In this rule change process the Commission's overall approach is to give more discretion with appropriate accountability to the AER to make appropriate regulatory decisions. In many areas there are objectives or factors for the AER to consider. Indeed, in relation to capex and opex allowances there are considerations for the AER's decision making in the criteria, objectives and factors. The Commission is of the view that seeking to limit the AER's discretion in a general way is not consistent with this. The NSP's proposal is a significant input, but there should be other factors and information for the AER to consider.

Furthermore, the Commission shares the view that there is insufficient evidence to support the restriction on the remaining provisions. As the AER has pointed out:

“To the extent these clauses oblige the AER to take into account an NSP's proposal, this is already achieved by clauses 6.10(1)(b)(1), 6.11(1)(b)(1), 6A.12.1(a1)(1) and clause 6A.13.1(a1)(1). Further, administrative law requires the AER to have due regard to all relevant information before it when making decisions. The information in an NSP's proposal is *clearly* relevant information.²⁰⁹ [emphasis added]”

As discussed further below, all public decision makers must base their decisions on sound reasoning and relevant information. Therefore, the final rule does not include clause 6.12.3(f) and clauses 6A.13.2(a). The way that the AER exercises its judgment in respect of the proposal and the rest of the evidence may achieve the same result as clause 6.12.3(f), but the NER will no longer prescribe it.

²⁰⁸ AER, Draft Rule Determination submission, 5 October 2012, pp. 10-11.

²⁰⁹ *Id.*, p. 11.

8.4.2 Benchmarking

The Commission is of the view that the removal of the "individual circumstances" clause does not enable the AER to disregard the circumstances of a NSP in making a decision on capex and opex allowances. Benchmarking is but one tool the AER can utilise to assess NSPs' proposals. It is not a substitute for the role of the NSP's proposal. Should the phrase remain, it appears that the AER's interpretation of it may restrict it from utilising appropriate benchmarking approaches to inform its decision making.

The Commission considers that the removal of the "individual circumstances" phrase will clarify the ability of the AER to undertake benchmarking. It assists the AER to determine if a NSP's proposal reflects the prudent and efficient costs of meeting the objectives. That necessarily requires a consideration of the NSP's circumstances as detailed in its regulatory proposal.

Under the first expenditure criterion the AER is required to accept the forecast if it reasonably reflects the efficient costs of achieving the opex objectives. These include references to the costs to meet demand, comply with applicable obligations, and maintain quality, reliability and security of supply of services and of the system. These necessarily require an assessment of the individual circumstances of the business in meeting these objectives. So to the extent that different businesses have higher standards, different topographies or climates, for example, these provisions lead the AER to consider a NSP's individual circumstances in making a decision on its efficient costs.

The ENA states that the important function of the phrase is highlighted by the Tribunal case regarding Powercor's vegetation management.²¹⁰ SA Power Networks, CitiPower and Powercor also reference this case by highlighting that the AER is not immune to errors and that the phrase reminds it to have regard to those circumstances which are relevant to any benchmarking exercise. However, the Commission notes that the judgement does not explicitly state which clause, or phrase within a clause, it has based its decision to remit the decision back to the AER. Specifically, the Tribunal stated that the AER's consultant failed to pay proper account of the differences between Powercor's network and work program and those of the other DNSPs.²¹¹

Annual benchmarking reports

The Commission notes that most stakeholders are supportive of the annual benchmarking reports. It does not accept the reasons provided by Ergon that the AER should have discretion in respect of whether or not to produce/publish such reports.²¹²

The intention of a benchmarking assessment is not to normalise for every possible difference in networks. Rather, benchmarking provides a high level overview taking

²¹⁰ ENA, Draft Rule Determination submission, 4 October 2012, p. 35.

²¹¹ *Application by United Energy Distribution Pty Limited* [2012] ACompT 1, [666]

²¹² Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 7.

into account certain exogenous factors. It is then used as a comparative tool to inform assessments about the relative overall efficiency of proposed expenditure. This view is consistent with that put forward in a submission by Grid Australia to the consultation paper.²¹³ Further, it is intended that the annual benchmarking report will be a useful tool for stakeholders, such as consumers, to engage in the regulatory process and have better information about relative performance of their NSPs. An expectation of annual publication adds to that value. The Commission therefore determines that the annual benchmarking report remain an annual obligation.

The Victorian DPI also raised the issue that the ability to carry out meaningful benchmarking relies on gathering data from the NSPs. Specifically it states that:

“Without systematic and comparable data from all NSPs, the AER will not be able to draw inferences about an individual NSP's performance against a benchmark with sufficient rigor to support its use as an analytical tool informing decisions in pricing reviews. The mere fact of publication of a benchmarking report may not materially improve the AER's pricing determinations.”²¹⁴

The Victorian DPI noted that the SCER has not yet responded to the AEMC's recommendations for improved data collection in the TFP Review. As a result, the Victorian DPI has suggested that the AEMC make a substantially similar rule to support the AER's role in assessing efficient network expenditure.²¹⁵ The Commission is sympathetic to the Victorian DPI's concerns, however, it is not appropriate to include such provisions at this stage, as they would not have been subject to consultation. The Commission stresses the importance of quality data collection (including on an annual basis) by the AER to support the changes in this final rule. It notes that this is a point of difference between the AER's practice and that of best practice highlighted by Brattle.²¹⁶ As noted in the draft rule determination, the SCER may wish to consider changes to the NEL to facilitate annual data collection by the AER for the purposes of benchmarking reports.

8.4.3 Engagement on expenditure models

In the draft rule determination the Commission introduced a requirement for the AER to develop a standard expenditure forecasting methodology. The AER would determine at the framework and approach stage how the methodology should be applied by a specific NSP which it would be required to include in their regulatory proposals, in addition to any differing approach they may take. This was determined on the basis that it would facilitate engagement on the expenditure forecasting methodologies adopted by NSPs as well as enable the AER to compare information

²¹³ Grid Australia, Consultation paper submission, 8 December 2011, p. 9

²¹⁴ Victorian DPI, Draft Rule Determination submission, 2 November 2012, pp. 1-2.

²¹⁵ Id, p. 2

²¹⁶ The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 28.

from NSPs on a similar basis. The AER is strongly supportive of the draft rule whereas NSPs are strongly opposed to the imposition of forecasting methodologies to address the problems raised.²¹⁷ However, there is agreement that early engagement on expenditure models is desirable.²¹⁸ Each of these issues is discussed in turn below.

Standard expenditure forecasting model

The ENA raises a number of concerns with the Commission's approach to impose a standard expenditure model. Primarily, these appear to centre around the NSP's role in managing its network and that linkage with the expenditure forecasts. Because of the NSP's role in daily planning and operation of the business, it should be able to produce the best information. Moreover, that the role and responsibility of developing the approach to forecasting should be consistent with the accountability for expenditure outcomes. The ENA further states that this is consistent with internal sign-off that the forecast expenditure reflects the expenditure which is truly required by the NSP.²¹⁹

The Commission accepts that responsibility for developing a NSP's proposal should remain with the NSP. This includes the development of an expenditure forecast in a manner that the NSP views as appropriate. It is the AER's role to assess the NSP's proposal using any tools it views as appropriate. Nevertheless, it remains important for the AER to receive information which enables it to effectively assess a NSP's proposal and be aware of how the NSP plans to forecast its expenditure. The ENA has proposed that the AER develop a guideline for its assessment techniques.²²⁰ The Commission sees merit in this approach.

As a result, the final rule requires the AER to develop guidelines on its assessment techniques. At the framework and approach stage the AER will determine how the guidelines apply to the particular NSP. The NSP is then required to submit information in compliance with the application of the guidelines as determined in the framework and approach paper *with* its proposal. This information would not form part of the NSP's formal proposal and therefore should not need to be subject to the same sign-off requirements as the proposal. There will no longer be a requirement to include in the proposal itself a forecast determined in a manner set by the AER. However, the final rule does not preclude the NSP from including the information in its proposal if it so chooses.

The assessment techniques included in the AER's guidelines are not an exhaustive list of all the techniques the AER may apply. In particular, after reviewing the NSP's regulatory proposal the AER may decide it wants to use additional assessment techniques it has not previously expected to use.

²¹⁷ AER, Draft Determination submission, 5 October 2012, p.12.; ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-36; Jemena, Draft Rule Determination submission, 4 October 2012, pp. 10-14.

²¹⁸ ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-36; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 19

²¹⁹ ENA, Draft Rule Determination submission, 4 October 2012, pp. 30-31.

²²⁰ *Id.*, p. 33.

The final rule should address the NSPs' concerns regarding internal sign-off as the information required is not part of the NSP's proposal. Further, the Commission notes that the rules do not require an overall executive level sign-off on the regulatory proposal. However, the rules do allow the AER to obtain the information it requires to assess the NSP's proposal.

Engagement on NSPs' expenditure forecasting models

The Commission remains of the view that early engagement on expenditure models is desirable. This view is shared by NSPs in submissions.²²¹ The ENA has proposed an alternative to the Commission's approach in the draft rule determination - that NSPs advise the AER of their forecasting methodologies at the framework and approach stage.²²²

The Commission agrees that engagement on expenditure models can be facilitated in ways other than that included in the draft rule. Indeed, a rule is not strictly required to enable engagement, as SP AusNet noted:

“in a cooperative approach to the conduct of the price review it is incumbent on the service provider and AER to meet early in the review process, and periodically, to discuss relevant matters, including the form of outputs from the service providers expenditure forecasting models.”²²³

The Commission is reluctant to formalise a requirement for engagement. However, expenditure models are an integral component in the assessment process such that mandating a minimum requirement for engagement provides a starting point in this important area. Therefore, the Commission's final rule determination is to adopt the ENA's proposal that NSPs will be required to advise the AER of its approach to expenditure forecasting. That is, the NSP and the AER will engage on the information requirements for the AER's assessment models, as well as how the NSP approaches expenditure forecasting.

The Commission views the early engagement with NSPs, as well as broader industry engagement in developing the guidelines, as beneficial. It will potentially save time and effort for both parties once the regulatory process has commenced.

8.4.4 Capex and opex factors

SA Power Networks, CitiPower and Powercor proposed that the inclusion of "any other factor" be identified in the framework and approach paper.²²⁴ The Commission

²²¹ ENA, Draft Rule Determination submission, 4 October 2012, pp. 29-36; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 19; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 3-4.

²²² ENA, Draft Rule Determination submission, 4 October 2012, p. 33.

²²³ SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 4.

²²⁴ SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2010, p. 19.

agrees that raising any other factor at the framework and approach stage is a reasonable suggestion as well being a convenient forum to discuss any additions. However, it notes that there are currently no limits on what the AER includes in the framework and approach paper so no rule is required for such an outcome to occur. It would not be appropriate to mandate such an approach. It is noted that clause 16(1)(b) of the NEL protects a NSP from any material change in the AER's analysis without notification.

The AER submitted that it should be able to raise any other factor prior to the submission of a revised regulatory proposal. This would allow it to consider other relevant factors which may arise after the submission of a NSP's regulatory proposal. It states that there appears to be no justification to exclude any relevant factors so long as the NSP is informed of them up to the cross submissions stage.²²⁵ The Commission sees the potential for relevant factors to arise following the submission of the proposal. However, it does not see that the AER should be able to raise a new factor up to the cross submissions stage. This stage is discretionary and designed to address matters raised in submissions. Accordingly, the clause will be amended to reflect that the AER can raise a new factor up to the submission of a revised regulatory proposal. The Commission considers that the existing capex and opex factors are sufficiently broad that it should be rare that the AER would need to consider additional factors.

Energex has proposed that the factor which requires the AER to have regard to the latest annual benchmarking report be broadened to refer to benchmarking material more generally.²²⁶ The Commission agrees that there may be other benchmarking information available to the AER, some of which may be more relevant than the annual benchmarking report. However, the AER's consideration of such material is not precluded from the rule as in addition to the most recent annual benchmarking report it also states the benchmarking expenditure that would be incurred by an efficient NSP. The consideration of a benchmark NSP enables consideration of broader benchmarking information. As such, the Commission's final rule determination is not to make any changes to this factor.

8.5 Guidance on final rule

8.5.1 Clarifying the discretion of the regulator

The NSP's proposal is necessarily the procedural starting point for the AER to determine a capex or opex allowance.²²⁷ The NSP has the most experience in how a network should be run, as well as holding all of the data on past performance of its network, and is therefore in the best position to make judgments about what expenditure will be required in the future. Indeed, the NSP's proposal will in most cases be the most significant input into the AER's decision. Importantly, though, it

²²⁵ AER, Draft Rule Determination supplementary submission, 25 October 2012, p. 6.

²²⁶ Energex, Draft Rule Determination submission, 4 October 2012, p. 2.

²²⁷ See also comments made in The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraphs 14 and 71.

should be only one of a number of inputs. Other stakeholders may also be able to provide relevant information, as will any consultants engaged by the AER. In addition, the AER can conduct its own analysis, including using objective evidence drawn from history, and the performance and experience of comparable NSPs. The techniques the AER may use to conduct this analysis are not limited, and in particular are not confined to the approach taken by the NSP in its proposal.

While the AER must form a view as to whether a NSP's proposal is reasonable, this is not a separate exercise from determining an appropriate substitute in the event the AER decides the proposal is not reasonable. For example, benchmarking the NSP against others will provide an indication of both whether the proposal is reasonable and what a substitute should be. Both the consideration of "reasonable" and the determination of the substitute must be in respect of the total for capex and opex.

The criteria for determining capex and opex contain a requirement that the AER must accept a proposal that is reasonable. It seems almost to go without saying that the AER must accept such a proposal. Why the AER would ever need to reject a proposal that it has determined is reasonable is unclear. The idea of reasonableness was used at times in consultation in 2006 to refer to a "reasonable range".²²⁸ This is a concept that can be misleading in the context of the exercise the AER must conduct in determining a capex or opex allowance. The AER has confirmed that it does not generally approach capex and opex allowances by determining a maximum and minimum possible allowance, and indeed the lack of precision inherent in this exercise would mean this has little benefit.²²⁹ The use of the term "reasonable" merely reflects this lack of precision. Thus, the AER could be expected to approach the assessment of a NSP's expenditure (capex or opex) forecast by determining its own forecast of expenditure based on the material before it. Presumably this will never match exactly the amount proposed by the NSP. However there will be a certain margin of difference between the AER's forecast and that of the NSP within which the AER could say that the NSP's forecast is reasonable. What the margin is in a particular case, and therefore what the AER will accept as reasonable, is a matter for the AER exercising its regulatory judgment.

The Commission remains of the view that the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own.²³⁰ The obligation to accept a reasonable proposal, reflects the obligation that all public decision-makers have to base their decisions on sound reasoning and all relevant information required to be taken into account. Some submissions have referred to the concept of an evidentiary burden, or onus of proof, as some submissions have termed it, that the AER has.²³¹ To the extent the AER places probative value on the NSP's proposal, which is likely given the NSP's knowledge of its own network, then the AER should justify its conclusions by reference to it, in the same way it should regarding any other submission of probative value. In circumstances where the NSP is required to provide information in support of

²²⁸ AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 52.

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

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

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

its proposal, and the AER is required to explain its decision, an evidentiary burden does not appear to reside with one party more than another.

When the AER assesses an expenditure forecast it has certain criteria to assess the forecast against, and certain factors it must bear in mind. These criteria broadly reflect the NEO, and include the efficient costs of a prudent operator and a realistic expectation of demand. The AER assesses the total of the capex or opex forecast and is not required to consider individual projects. The Commission considers that the rules give the AER sufficient freedom to set capex and opex allowances that are efficient, assuming it applies appropriate analytical techniques and has access to an appropriate level of information.

8.5.2 Benchmarking

The final rule gives the AER discretion as to how and when it undertakes benchmarking in its decision-making. However, when undertaking a benchmarking exercise, circumstances exogenous to a NSP should generally be taken into account, and endogenous circumstances should generally not be considered. In respect of each NSP, the AER must exercise its judgement as to the circumstances which should or should not be included. However exogenous factors to be taken into account are likely to include:

- geographic factors: topography and climate;
- customer factors: density of the customer base (urban v rural), load profile, mix of customers between industrial and domestic;
- network factors: age, mix of underground and overhead lines, though this will depend on the extent to which this is at the election of the NSP; and
- jurisdictional factors: reliability and service standards.

If there are some exogenous factors that the AER has difficulty taking adequate account of when undertaking benchmarking, then the use to which it puts the results and the weight it attaches the results can reflect the confidence it has in the robustness of its analysis.

Endogenous factors not to be taken into account may include:

- the nature of ownership of the NSP;
- quality of management; and
- financial decisions.

It is also expected that similar considerations be made when undertaking the annual benchmarking report.

8.5.3 Engagement on expenditure models

The final rule requires the AER to develop expenditure forecast assessment guidelines. The guidelines will set out the types of assessments the AER will undertake in approving expenditure allowances and the information requirements from NSPs to facilitate those assessments. At the framework and approach stage the AER will document any deviations as well as specific information requirements as they apply to the NSP under review. The NSP will also be required to advise the AER of its approach to expenditure forecasting at least 24 months before the expiry of its existing determination. The timing is intended to coincide with the framework and approach stage and so the NSP could include a description of its intended approach in its submission to avoid a separate step and provide context for the AER's assessment approach.

When the NSP submits its proposal it is required to submit an accompanying document complying with the requirements of the expenditure forecast assessment guidelines, or as otherwise specified in the framework and approach paper. This document is not, nor does it form part of, a NSP's expenditure forecast as included in its proposal unless the NSP chooses to include complying information as part of its proposal. Therefore, the director certification requirements under clause S6.1.1(5) would not apply as it does not form part of the capex or opex forecasts. However, under the NER accompanying information can be requested to be resubmitted for non-compliance under clause 6.9.1.

The intention of this final rule is to facilitate early engagement on a NSP's expenditure forecast methodology and ensure that both the AER and NSPs are aware, in advance, of the information the AER requires to appropriately assess a NSP's proposal. It is intended to bring forward and potentially streamline the regulatory information notice stage(s) that currently occur, as well as to expedite the AER's understanding of the NSP's approach to expenditure forecasting. It does not restrict the AER's ability to use additional assessment techniques if it considers these are appropriate after reviewing a NSP's proposal.

8.5.4 Capex and opex factors

The "best endeavours" clause in the final rule for the AER to publish in advance analysis on which it proposes to rely, or to which it proposes to refer, for the purposes of the final regulatory determination means that the AER should publish such analysis unless there are time constraints or other reasons why it would be practically impossible for the AER to do so. The way this clause interacts with section 16(1)(b) of the NEL is critical. To the extent there is an inconsistency between those two provisions, the final rule is not intended to override the NEL, and indeed could not. The AER still has an obligation under the NEL provision to inform the relevant NSP of material issues under consideration and to give the NSP a reasonable opportunity to make submissions in respect of them.

As mandatory considerations, the AER has an obligation to take the capex and opex factors into account, but this does not mean that every factor will be relevant to every aspect of every regulatory determination the AER makes. The AER may decide that certain factors are not relevant in certain cases once it has considered them. In respect of the capex and opex factor that will be added which clarifies that the AER may consider additional factors, any additional factor must be notified to the relevant NSP prior to the NSP submitting its revised proposal.

In respect of the factor to be added which will allow for the AER to have regard to the extent to which NSPs have considered what consumers seek, there are various ways this could be relevant. For example, it may be the case that a majority of affected consumers are unhappy with the visual impact of a proposed new line. If the NSP engages with consumers, it may decide that the best way to address the concerns of consumers would be to build the line underground, even if this is a more expensive option. When the AER considers the NSP's overall capex proposal, it should take into account that the proposed option will provide a higher quality of service in line with consumers' preferences and willingness to pay, above less expensive options which fall below the level of service demanded by consumers. In general, a NSP that has engaged with consumers and taken into account what they seek could reasonably expect the AER to take a more favourable view of its proposal. The Commission expects that over time NSPs and the AER will, through their regulatory proposals and draft and final revenue determinations, develop examples of good practice by NSPs in engaging with consumers.

9 Capex incentives

Summary

- Incentives to seek efficiencies decline during regulatory periods and there is a lack of supervision of capex above the allowance.
- The Commission's approach to addressing these problems is to provide the AER with a number of "tools" which it can apply. These tools will include:
 - capex sharing schemes to be designed by the AER;
 - efficiency reviews of past capex, including the ability to preclude inefficient expenditure from going into the RAB up to an amount that is equal to the amount of expenditure above the allowance; and
 - deciding whether to depreciate the RAB using actual or forecast expenditure to establish a NSP's opening RAB.
- These tools should be viewed alongside the ability of the AER, on an ex ante basis, to scrutinise effectively, and if necessary amend, proposed capex as part of the determination process to set efficient allowances in the first place.
- An overall capex incentive objective describes what the capex incentive regime, as a whole, aims to achieve. The AER will be required to take into account a number of principles and factors when designing and applying the capex incentive tools.
- In addition, regardless of whether a NSP spent more than its allowance, the AER has the ability to preclude expenditure from being rolled into the RAB to the extent that expenditure comprises:
 - inefficient related party margins; or
 - capitalised expenditure as a result of within period changes to the NSP's capitalisation policy.
- Reviews of efficiency of past capex should not be seen as diminishing the role of ex ante incentives. Rather, such reviews are to address a gap in the lack of supervision of capex that has occurred. The ability to reduce the capex rolled into the RAB is intended for obvious cases of inefficiency, and not as the main means of achieving efficient levels of capex.
- A review of efficiency of past capex for the purpose of identifying inefficient expenditure to preclude from the RAB may initially consider benchmarking information and focus on the governance processes and procedures of the NSP. A NSP that follows good practice and governance

should be able to demonstrate that its capex is efficient. The presence of a strong ex ante incentive could also provide a high level of assurance that capex is efficient.

Difference between draft rule and final rule

- The AER will only be able to preclude capex from going in the RAB from the first regulatory year after the capex incentive guidelines commence. Any capex incurred prior to this time will not subject to this provision.
- The AER will be required to set out in the capex incentive guidelines its approach to assessing whether capitalised expenditure is consistent with the NSP's capitalisation policy.

9.1 Introduction

The role of capex incentives is to encourage NSPs to incur efficient levels of capex - that is, to spend no more than necessary for a given level of reliability and broader service quality. Currently, a NSP is required under the NER to forecast its requirements for capex for the forthcoming regulatory control period. In the regulatory determination, the AER either approves this forecast or does not approve it and replaces it with its own forecast which then becomes the allowance.²³² This allowance is the basis of an incentive for a NSP. If a NSP spends more than its allowance, it bears the costs of this expenditure above the allowance for the remainder of the period.²³³ Conversely, if it spends less than its allowance it retains the benefit for the rest of the period.

The AER claimed that the NER provide an incentive for NSPs to spend more than efficient levels of capex for a regulatory control period.²³⁴ This is claimed to be the case particularly where the NSP's allowed rate of return was higher than its actual cost of capital and where the NSP was responding to non-financial incentives it may face. The AER proposed to prescribe in the rules an adjustment to the RAB roll forward such that a NSP could only recover 60 per cent of the cost of any over expenditure (the 60/40 sharing mechanism).²³⁵ It also requested that it be given the discretion to roll forward the RAB using depreciation based on actual or forecast capex as a means of providing an additional incentive. The AER currently has this discretion in Chapter 6 (distribution) but not in Chapter 6A (transmission).

In addition to the broader capex incentive issue, the AER considered that the NER provide an incentive for NSPs to inefficiently incur capitalised related party margins

²³² The AER does not approve augmentation capex for TNSPs in Victoria; this is determined instead by AEMO.

²³³ The cost the NSP bears is the cost of financing the extra capex, so these costs are for depreciation incurred and foregone return on the capex.

²³⁴ AER, Rule change request, Part B, 29 September 2011, p. 38.

²³⁵ In this chapter, phrases such as capex 'going into the RAB' or being considered at the 'RAB roll forward' are generally referring to the RAB which is adjusted and locked in for the next regulatory control period; Id., p. 40.

and to replace opex with capex through changes to their capitalisation policies during a regulatory control period.²³⁶

The remainder of this chapter is structured as follows:

- Section 9.2 summarises the Commission's position in the directions paper and draft rule determination;
- Section 9.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 9.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- Section 9.5 provides the guidance on the final rule.

9.2 Directions paper and draft rule determination

9.2.1 Background analysis

In the draft rule determination the Commission did not consider that capex incentives in the NER provide an incentive for NSPs to spend more than their allowance. It noted in the directions paper that a NSP could make a judgement on a forward looking basis as to the possible difference between its allowed cost of capital and its true cost of capital. This could provide a basis to support an overspend, but capex incentives should not be designed to address cost of capital matters. However, there are factors outside of the NER that may provide incentives for capex beyond the allowance.²³⁷

Following on from this, the Commission identified two key issues with capex incentives in the NER. These were that:

- the incentive to make efficiency improvements declines during the regulatory control period, which has implications for the timing of capex and substitution between opex and capex; and
- capex above the allowance is subject to a lack of regulatory scrutiny, which means that there is a risk that any expenditure above this allowance may be inefficient.²³⁸

In addition, further work undertaken for the Commission by Parsons Brinckerhoff identified that there were a number of potential drivers for overspends during a regulatory control period by NSPs. These included for example corporate governance,

²³⁶ Id., pp. 53-56; AER response to AEMC queries on AER network regulation rule change proposals, 1 February 2012, pp. 7-10.

²³⁷ AEMC, *Consolidated Rule Request - Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. iii.

²³⁸ Id., pp. 34, 40, 43.

project delivery risks and uncontrollable events. The Commission observed that the majority of these drivers could be mitigated or at least partly controlled. Some drivers, however, such as unexpected growth in demand for new connections and compliance with unanticipated regulatory obligations or requirements appeared harder to control than others.²³⁹

Parsons Brinckerhoff considered that the ability to defer expenditure was one of the ways in which some of the more uncontrollable factors might be mitigated. Similarly, it suggested that a NSP was likely to look more closely at options for deferring capex the closer it gets to exceeding its allowance. Parsons Brinckerhoff also noted that:

“In practice actual project costs will be both more than and less than original regulatory submission forecasts, so the net effect is an increase in the business's ability to offset overspending in one area against unpredicted savings or efficiencies realised in another in order to stay at or below the regulated allowance levels.

The exception to this is where low probability high impact events such as extreme weather events, or geopolitical economic shocks have a material effect on Capex. Such exceptions would be better handled by dedicated regulatory tools such as Capex re-openers.²⁴⁰”

Nothing in the work that Parsons Brinckerhoff undertook indicated that the current regulatory framework provides NSPs with an incentive to overspend their allowances. However, Parsons Brinckerhoff noted that insufficient regulatory oversight would strengthen the potential for capex overspends through a lack of consequences.²⁴¹

Further work undertaken by the Commission also provided support that the NER provides an incentive to defer capex to the end of a regulatory control period - there was some evidence that both the Victorian DNSPs and Ausgrid had deferred capex until the end of a period.²⁴²

9.2.2 Overall approach

The Commission's approach to addressing these problems was to provide the AER with a number of "tools" which it can apply as it considers necessary to provide adequate incentives for NSPs to spend capex efficiently. These tools include:

- capex sharing schemes;
- reviews of efficiency of past capex; and

²³⁹ Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 2 August 2012.

²⁴⁰ *Id.*, p. 33.

²⁴¹ Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 22 June 2012, p. 33.

- whether to depreciate the RAB using actual or forecast expenditure to establish a NSP's opening asset base.

These tools should be viewed alongside the ability of the AER, on an ex ante basis, to scrutinise effectively, and if necessary amend, proposed capex as part of the determination process to set efficient allowances in the first place.

The Commission considered that the AER is generally best placed to determine which of the tools can be best used to create incentives for individual NSPs rather than specific approaches being included in the NER. The flexibility inherent in the proposed approach would allow the AER to tailor the incentives to individual NSPs and adapt them over time. This recognises that the best incentives for efficient capex may not be the same for all NSPs or the same over time. However, with greater discretion, there must also be appropriate accountability and transparency to help provide certainty for stakeholders and confidence that the outcomes are in the best interests of consumers.

In seeking to provide this accountability and transparency the draft rule provided for an overall objective for capex incentives that was consistent with the NEO and RPP. This objective describes what the capex incentive regime, as a whole, should aim to achieve. It guides the AER in the development and application of the capex incentive tools. It is also relevant for the appeal body to consider this objective when assessing any merits reviews on elements of the capex incentives regime.

In addition, the Commission determined that the AER should be required to set out its approach to capex incentives in guidelines. This is where the AER would set out the approach to capex sharing schemes, how it would undertake efficiency reviews of past capex and how it would determine whether to use actual or forecast expenditure for the purpose of depreciating the RAB. The draft rule also required the AER to set out how its approach to capex incentives overall met the capex incentive objective thereby requiring it to take a coordinated approach to capex incentives. The specific regulatory determination for each NSP would set out which approaches would apply to the NSP and how.

Finally, the draft rule also required the AER to consider principles in the NER when it develops and then applies each of the tools.

9.2.3 Capex sharing schemes

Capex sharing schemes allow for the sharing of efficiency gains and losses from capital expenditure between NSPs and consumers. In general regulators have approached such schemes by allowing NSPs to retain a set portion of any efficiency gains they make and bear a set portion of any efficiency losses it incurs against the benchmark. Often the benchmark is the allowance set by the regulator. The ratio of sharing of the efficiency gains and losses between the NSP and consumers is known as the incentive

242 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 123-124.

rate. The AER could use capex sharing schemes to set incentives so that the most efficient NSPs earn the highest rewards and those that are inefficient are penalised.

The Commission identified the following benefits with capex sharing schemes in the draft rule determination:

- they encourage appropriate network investment;
- they encourage NSPs to look for efficiencies, such as by innovation;
- they provide an incentive for NSPs to reveal their efficient costs; and
- they can be designed to provide for a continuous incentive, that is, the incentives could be set so that the incentive power is the same no matter in which year of a regulatory control period an investment is made.

In this way, a capex sharing scheme can give the AER greater confidence that capex going into the RAB is efficient.

The Commission noted one potential problem with capex sharing schemes is that it can be difficult to identify whether reductions in capex are from efficiency gains or inefficient deferral. A capex sharing scheme should not encourage actions that would later lead to degradation of network quality and consequent reductions in service quality. It determined that while there may be difficulties in applying these schemes, the benefits should outweigh these difficulties. On balance, it considered there is room for further innovation in this area.

To provide for certainty the Commission considered that the AER should be required to take into account some principles in designing and applying capex sharing schemes. Importantly, the Commission did not support a principle that a capex sharing scheme should be continuous. Although in most cases a continuous incentive is preferable to a declining incentive it considered a principle of this nature could discourage some schemes which are appropriate. For example, a non-continuous scheme may be relevant when considered alongside the other capex incentive tools such as the reviews of efficiency of past capex.²⁴³

Similarly, the Commission did not consider it appropriate that the AER be required consider whether the a scheme should be "mathematically symmetrical".²⁴⁴ Such an approach would be overly prescriptive and could prevent some schemes that would be beneficial.

²⁴³ A constant incentive power is relevant in capex in order to provide an equal incentive to invest in each year of a regulatory control period. Anything other than an equal incentive may provide incentives for NSPs to defer expenditure, even where it is not efficient to do so. In addition a declining incentive in capex and a constant incentive in opex may encourage inefficient substitution between opex and capex.

²⁴⁴ In this context, mathematical symmetry refers to an improvement or decline in capex relative to a benchmark which is of the same absolute value accruing the same reward or penalty in absolute value terms.

The Commission proposed that the AER should be able to apply schemes in a different way to different NSPs or even to apply different schemes to different NSPs. This would enable the AER to tailor its approach to individual NSPs. So, for example, the AER could apply what were regarded as stronger incentives for NSPs that traditionally spend more than their allowance and weaker incentives where the AER is concerned about inefficient deferral into future regulatory control periods. For the avoidance of doubt, the AER can also develop different schemes for DNSPs and TNSPs.

9.2.4 Reviews of efficiency of past capex

Reviews of the efficiency of past capex generally encompass the regulator determining whether to allow the future recovery of incurred capex. Reviews of the efficiency of past capex are found in many other jurisdictions, and have been widely adopted in Australia.²⁴⁵

The Commission took the view in the draft rule determination that reviews of efficiency of past capex are the most direct way of addressing the lack of supervision problem since they give the regulator the chance to check that the capex to be recovered is efficient. In addition, the risk of an inability to recover for inefficient expenditure would provide an incentive for NSPs to avoid inefficient capex. Ex ante incentives may not always provide adequate assurance that capex is efficient. A further check that what is rolled into the RAB is efficient would therefore be in the long term interests of consumers. The review of efficiency of past capex should also assist the AER in determining an appropriate ex ante allowance by permitting it to better understand how efficient a NSP has been in the previous period and what projects it has undertaken. It should also improve understanding of the reasons for any overspends.

Importantly, the Commission considered that if a NSP is well run and its management has in place robust processes for deciding which capex projects to undertake and regularly reviews and reassesses its capex program it should have nothing to fear from a review of its efficiency. Indeed, such a review should act to give the regulator greater confidence about the efficiency of the NSP's future capex projections. It was not convinced that the evidentiary burden for the AER would be any different from the evidentiary burden that the AER has when it considers ex ante allowances.

The Commission proposed two elements to the review of efficiency of past capex tool:

- reducing the amount of capex to go into the RAB; and
- a statement on the efficiency of past capex.

Reducing the amount of capex to go into the RAB for inefficient expenditure

The Commission proposed in the draft rule determination that the AER could only reduce the amount of capex to go into the RAB as a result of a review of efficiency of

²⁴⁵ Id., p. 134.

past capex if the NSP had spent more than its allowance for the relevant period. In addition, the amount of expenditure that the RAB could be reduced by would be restricted to the amount of any expenditure above the allowance for the same period. It would be the AER's decision as to whether it considers it appropriate in the specific circumstances to exercise this power.

The Commission considered that setting the best possible ex ante allowance for capex is important, and that the use of ex ante incentive mechanisms for capex has the potential to provide important incentives for efficiency and innovation in capex that may not occur if reliance was placed on reviews of the efficiency of expenditure after it has occurred. Therefore, it is appropriate for NSPs to only be at risk of capex not going into the RAB if they have overspent the ex ante allowance. This approach would also mitigate any potential for an increase in regulatory risk as a result of the introduction of this tool.

In addition, the Commission considered that if the capex undertaken is the same or very similar to that which the NSP set out in its regulatory proposal then the ex ante assessment of the projects should provide a degree of confidence about the likely efficiency of the expenditure below the allowance. That is, while the nature of the actual capex undertaken need not be identical to what was included in the ex ante allowance, that allowance represents an efficient quantum and expenditure below this amount could be expected to be efficient at an overall level.

Further, given that the ex ante allowance, as a total, represents a forecast of an efficient level of expenditure for the NSP there should be little need for the NSP to spend above this amount in normal circumstances. As the Parsons Brinckerhoff report indicated, while there are often unexpected additional costs for a NSP during a regulatory control period, there will also be unexpected reductions in costs.²⁴⁶ In addition, the NSP should be able to take mitigating actions, such as re-prioritising capex, to avoid spending over its allowance, or seek a cost pass through if the relevant test is met. Indeed, on this basis, the Commission suggested there was an argument that no capex above the level of the ex ante allowance should be rolled into the RAB. However, to accommodate unforeseen circumstances where a NSP legitimately spent more than its allowance, the AER should have the ability to make an assessment of the amount of any overspend that may be rolled into the RAB.

In this way, the focus in the draft rule on the overall amount to be rolled into the RAB was intended to encourage the AER to undertake a review of the efficiency of the total capex incurred by the NSP during the specified period rather than just looking at individual projects. The Commission noted that in undertaking a review the AER could consider, among other things, whether the NSP could have avoided spending more than its allowance for the period by deferring projects through re-prioritisation. The draft rule was intended to allow the AER to use a range of analytical techniques to assess the efficiency of capex including benchmarking and the assessment of individual projects. The AER could also consider the effectiveness of the NSP's planning and

²⁴⁶ Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, Report for the AEMC, 2 August 2012, p. 33.

prioritisation processes for capex to try and gain assurance about the robustness of its decision-making.

The Commission proposed that the AER should set out in the capex incentive guidelines whether and how it intends to undertake reviews of efficiency to determine whether to reduce the amount of capex to go into the RAB. This approach should take into account the other tools it has.

The draft rule determination set out three key elements of the draft rule.

First, it is significant that the test in the draft rule that the AER must apply in determining whether to reduce the RAB as a result of inefficient expenditure is essentially the same as it is for assessing forecasts of capex on an ex ante allowance - that is, whether or not the expenditure reasonably reflects the capex criteria. This was the appropriate test for the efficiency of capex determined by the AEMC in 2006 and it continues to remain valid. The AER now has several years of experience in applying this test and a body of regulatory precedent has been developed.

Second, in determining whether to reduce the amount to be rolled into the RAB the AER should only take into account information and analysis that the NSP could reasonably be expected to have had access to at the time it undertook the capex.

Finally, whilst an AER decision to reduce the amount of capex to go into the RAB as a result of an inefficient capex overspend would not itself be a constituent decision, it would form part of the constituent decision as to the opening value of the regulatory asset base. As a result, this reduction would be subject to the same consultation process as the determination process and, more significantly, merits review.²⁴⁷ It is important for accountability that a NSP be able to seek an appeal body's review of any decision to reduce its capex rolled into the RAB in this way. While the decision would be subject to merits review, the Commission considered it is very important that any review of the AER's decision considers as a minimum the totality of its approach to capex incentives. This is because a decision that focussed only on the outcomes of the review of expenditure after it has been incurred, but did not have regard to, for example, any ex ante sharing mechanisms, may reach a conclusion that is not consistent with the overall capex objective and the NEO.

Statement on the overall efficiency of capex being rolled into the RAB

In addition to allowing the AER to reduce the amount of capex to go into the RAB as a result of a review of efficiency of past capex, the Commission proposed in the draft rule determination that the AER be required to make a statement on the overall efficiency of capex going into the RAB in its draft and final regulatory determinations for each NSP. This would require the AER to consider the overall efficiency of capex going into the RAB for all NSPs, not just those that have spent more than their allowance. This recognises the principle that capex below the allowance can still be inefficient.

²⁴⁷ What is subject to merits review in the future will depend on any changes agreed by the SCER after considering the LMR Panel report.

The Commission considered the obligation to make a public statement on the efficiency or otherwise of what is going into the RAB may be useful in terms of providing information and analysis to consumers and their representatives. Undertaking the review itself could be considered beneficial as a complement to ex ante reviews of capex. For a start, it is common practice that these reviews are carried out at the same time as the ex ante allowances are determined for the next regulatory control period. There are good reasons for this. As Brattle has observed in respect of the task of conducting reviews of the efficiency of past capex:

“in practice, this task is frequently carried out in parallel with reviewing capex forecasts, for example through the use of technical consultants, and perhaps because both tasks require the same data and expertise.”²⁴⁸

This obligation was incorporated as part of the overall approach towards a greater focus on the efficiency of NSPs in the NER. In line with the overall approach of giving the AER greater discretion and allowing flexibility, few requirements were included in the draft rule around how the AER must undertake this task. For consistency the overall test for efficiency is the same as that to be applied where the AER considers whether to make a reduction to the capex to be rolled into the RAB, and the same as that currently in the rules for the assessment of an ex ante forecast. The AER should, when it develops its Regulatory Information Notice (RIN), consider the information that it will require to assess the efficiency of capex that has been undertaken during the regulatory control period.

9.2.5 Depreciation

The Commission engaged Economic Insights to provide advice on the incentive effects of using actual versus forecast depreciation when rolling forward the RAB. Economic Insights designed a model to measure how much benefit is retained by a NSP over the life of the asset if it is able to make a saving against the capex allowance or how much is lost if the NSP overspends. This is the "incentive power" and is the portion of any efficiency saving that the NSP keeps. Similarly if the NSP overspends relative to the allowance, it is the proportion of that cost which it bears. The incentive power was calculated for asset lives of 10, 20, 30, 40 and 50 years using both forecast and actual depreciation for comparison.²⁴⁹

The results of Economic Insights' modelling indicate:

1. the incentive power under an actual depreciation approach is higher than the incentive power under a forecast depreciation approach. That is, a NSP will have a stronger incentive to minimise capex relative to the allowance under an actual depreciation approach;

²⁴⁸ The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraph 54.

²⁴⁹ Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, pp. 14-15.

2. the incentive power under an actual depreciation approach differs depending on asset class whereas it is the same for all asset classes using forecast depreciation; and
3. the incentive to make any savings relative to the allowance declines through the regulatory control period and by year five results in no incentive to make savings.²⁵⁰

The modelling results confirmed the theoretical assessment of the relative incentive effects of depreciation approaches and analyses put forward in submissions.²⁵¹ Consequently, Economic Insights stated that:

“using forecast depreciation may be a preferable default as the use of actual depreciation is a second best substitute for having a capex EBSS [efficiency benefit sharing scheme], creates an incentive to substitute away from short life assets at a time when they may be becoming increasingly important to achieving efficient energy market outcomes and creates an incentive for NSPs to over-inflate their capex forecasts.²⁵²”

However, Economic Insights also conducted a review of recent Australian regulatory practice and found that the approach to depreciation varied across and within jurisdictions with regulators citing different reasons for using their chosen approach. In contrast, actual depreciation is the norm in the overseas jurisdictions surveyed. As a result, Economic Insights stated that:

“It has not been a case of 'one size fits all' and the approach used in each jurisdiction reflects the relative issues and concerns that have evolved in that jurisdiction.²⁵³”

Economic Insights thus concluded that it would be desirable to accord the AER flexibility in making the choice of depreciation approach in transmission as it currently has in distribution rather than prescribe a particular approach.

Further, the Commission decided that it was appropriate for the AER to have principles that it must take into account when exercising discretion on depreciation.

Therefore, the principles reflected the fact that depreciation is one component of a broader capex incentives arrangement, and that the incentives provided by the choice of depreciation methodology should be coordinated with other incentives for a NSP. For example any capex sharing scheme will be relevant, as this will directly increase

²⁵⁰ Note these results will differ slightly depending on the time of year it is assumed that capex is undertaken. Economic Insights have assumed that capex is incurred at the end of the year: *Id.*, p. 14.

²⁵¹ ENA, Directions Paper submission, 16 April 2012, p. 33 and ENA, Directions Paper submission, Attachment C, 16 April 2012, p. 8.

²⁵² Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, Report for the AEMC, 31 May 2012, p. 42.

²⁵³ *Id.*, p. 33.

the power of the incentive. The power of the incentive for opex is also a relevant consideration to the extent that opex or elements of opex can be substituted with capex. The view was taken that it was undesirable to have incentives to reduce opex without corresponding incentives to reduce capex such that any reductions in opex can be offset by investments in capex. The draft rule determination also noted the importance that incentives to reduce capex do not provide an incentive that could lead to a decline in service standards below the level valued by customers; the incentives provided by the STPIS should also be considered.

It was noted that the differing incentive rates for assets with economic lives of different lengths under the actual depreciation approach will affect whether it is appropriate to have these differing incentives to the extent that they are substitutable.²⁵⁴ This was because, should they be substitutable, it may distort investment decisions on input use which may ultimately impact consumers. The Commission decided that it was relevant to also consider both the proportional value of short-lived assets in the asset base and their likely current and future strategic importance to gauge the significance of such a risk.

Finally, in considering the appropriate capex incentive, the Commission took the view that it was also relevant to consider the past performance of the NSP. The AER may wish to apply incentives in a different way to a NSP that has historically overspent due to being inefficient compared to one that has underspent.

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

9.2.6 Related party margins and capitalisation policy changes

Related party margins

In a general sense, related parties are companies that are related to a NSP through common ownership.²⁵⁵ As identified by Covec, some NSPs engage related parties to perform various tasks. The related party margin refers to the difference between the contract price and the related party's actual direct costs to provide the service and may be capital in nature.²⁵⁶

The Commission acknowledged in the draft rule determination that there was a potential incentive for NSPs to incur inefficient capitalised related party margins. It noted that this incentive could be present regardless of whether a NSP spent more than

²⁵⁴ Id., p. 16.

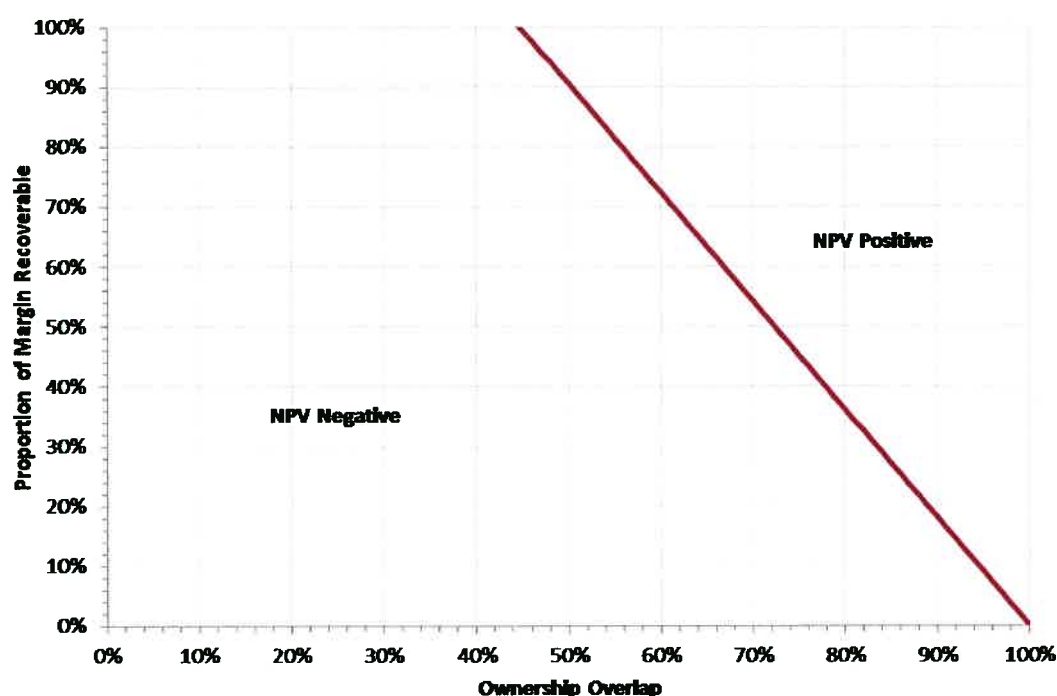
²⁵⁵ AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 54.

²⁵⁶ Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers*, Report for the AEMC, 31 May 2012, p. 1.

its allowance or not, and even where there were strong ex ante capex incentives in place such as a capex sharing scheme.

The results of a model developed for the Commission by Covec showed that when a NSP owns a large share of a related party it can be financially beneficial for the NSP to pay an inflated margin, even if something less than 100 per cent of that margin is allowed into the RAB.²⁵⁷ At smaller ownership shares it showed that it is not financially beneficial to pay an inflated margin, even if there is full pass through of the margin into the RAB.²⁵⁸ This is illustrated in Figure 9.1 below.

Figure 9.1 Incentives to pay related party margins



Source: Covec, *Analysis of the Use of Related parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, p. 21.

The Commission also referenced analysis undertaken by the AER on this issue.²⁵⁹ It suggested that this incentive could encourage NSPs to enter into commercial arrangements that are not the most efficient. It noted that the AER and Essential Services Commission of Victoria (ESCV) both felt that there was a need for additional measures to address excessive related party margins.²⁶⁰ To encourage NSPs to use the most efficient business structure the Commission determined that this issue should be addressed.

²⁵⁷ Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, p. iii.

²⁵⁸ Ibid.

²⁵⁹ AER, Directions Paper submission, 2 May 2012, p. 28.

²⁶⁰ For a summary of the measures undertaken by the AER and the ESCV see Covec, *Analysis of the Use of Related Parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012.

The Commission considered that the issue should be dealt with by reviewing the capex after it is undertaken. It therefore proposed to give the AER discretion to reduce the RAB by an amount that reflects the difference between:

- the margin that was paid; and
- the margin that the AER considers would have been paid if the related party margin had been referable to arrangements that had been on arm's length terms.

This is consistent with the capex factor in the NER that the AER must have regard to in determining the ex ante capex allowance.²⁶¹ The Commission considered that the AER should have this discretion regardless of whether the NSP spent more than its overall allowance. As noted above, a NSP could gain from inflating related party margins when it spends less than in its allowance as well as when it spends more than its allowance.

The Commission considered that a flexible or NSP-specific approach to determining the efficiency of related party margins would be optimal to recognise the differing incentive power in different circumstances. It put forward that the AER's current approach as described in the Covec report may lack the flexibility to take account of NSP specific circumstances.²⁶² That is, the AER could better tailor incentives to reflect the different circumstances, and so far as is reasonably possible provide an incentive for NSPs to deliver services in whichever way is most efficient, eg in house, related party providers or third party contractors. The Covec model was an example of how this approach could be developed.

The Commission proposed to require the AER to set out its approach to determining the efficiency of related party margins in the capex incentive guidelines. This would give NSPs and other stakeholders a chance to provide input on the AER's approach outside of the regulatory determination process, promote consistency in the application of the rule between NSPs, and provide greater certainty to NSPs as to how the AER will apply the rule.

Capitalisation policy changes

The Commission accepted that there was a potential incentive for NSPs to capitalise expenditure during a regulatory control period and thus recover the same expenditure twice: once in forecast opex and again through depreciation and return on capital once the expenditure is rolled into the RAB.²⁶³

Similar to related party margins, the Commission proposed to give the AER discretion to reduce the RAB by an amount that represents expenditure that has been capitalised as a result of within-period changes to the NSPs capitalisation policy. As per related

²⁶¹ See for example clause 6.5.7(e)(9).

²⁶² Covec, *Analysis of the Use of Related parties by Electricity Network Service Providers*, Report for the AEMC, 6 June 2012, pp. i, 8-9.

²⁶³ AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Draft Rule Determination, 23 August 2012, p. 150.

party margins, the AER should have this discretion regardless of whether the NSP has spent more than its overall capex allowance not. This is because a NSP may gain from changing its capitalisation policy regardless of whether it spends more than its allowance or not. The Commission suggested that in general a NSP should be able to avoid having to capitalise expenditure as a result of a change in its capitalisation policy. First, changes to the capitalisation policy in the first two to three years of a forthcoming regulatory control period should be less likely on the basis that they could have been included in the earlier regulatory determination. Second, any changes that a NSP wants to make in the final two to three years of a regulatory control period could be delayed until the start of the next regulatory control period.

9.3 Submissions

This section provides a broad overview of submissions received on the draft rule determination. Specific issues that were raised in response to the draft rule determination are considered in section 9.4.

While NSPs support giving the AER the ability to apply a variety of tools they consider that having a capex incentive objective in the NER is unnecessary given the existence of the NEO.²⁶⁴ Where they commented, other stakeholders were supportive of the overall approach taken in the draft rule determination.²⁶⁵

There was broad support from stakeholders for enabling the AER to develop a capex sharing scheme as one of the capex incentive tools.²⁶⁶ However, NSPs maintain that the AER should at least be directed to consider the desirability of a continuous and symmetrical incentive in developing these schemes.²⁶⁷

There were mixed views on reviews of efficiency of past capex. NSPs maintain that allowing the AER to reduce the RAB as a result of a review of the efficiency of past capex would add to regulatory uncertainty and risk and may therefore encourage NSPs to inefficiently defer or avoid capex. They also note the administrative cost of the reviews. They suggest that if reviews of the efficiency of past capex are to be allowed for then there should be more guidance in the NER as to when and how the AER should apply them.²⁶⁸

²⁶⁴ ENA, Draft Rule Determination submission, 4 October 2012, pp. 50-51.

²⁶⁵ AER, Draft Rule Determination submission, 5 October 2012, p. 13; IPART, Draft Rule Determination submission, 2 October 2012, p. 2; MEU, Draft Rule Determination submission, 4 October 2012, p. 25; Energy Australia, Draft Rule Determination submission, 15 October 2012, p. 2.

²⁶⁶ See, for example, ENA, Draft Rule Determination submission, 4 October 2012, p. 55.

²⁶⁷ Ibid; The Commission defines a continuous incentive as one where the incentive power is the same no matter which year of a regulatory control period an investment is made. It considers that mathematical symmetry refers to an improvement or decline in capex relative to a benchmark which is of the same absolute value, accruing the same reward or penalty, in absolute value terms.

²⁶⁸ Id., pp. 50, 59-60.

The majority of other stakeholders that commented are broadly in support of reviews of efficiency of past capex.²⁶⁹ The IPART, MEU and the SA Minister for Mineral Resources and Energy consider that the mechanism should be broadened to allow the AER to reduce the amount of capex to go into the RAB when a NSP has spent within its allowance.²⁷⁰ On the other hand, the EUAA and UnitingCare Australia are sceptical about the effect that reviews of efficiency of past capex might have due to the practical difficulties for the regulator in undertaking them.²⁷¹ There was also a concern that NSPs may be able to claim higher rates of return as a result of the mechanism.²⁷²

Few stakeholders commented on the decision to give the AER discretion to use actual or forecast expenditure for the purpose of calculating depreciation to establish the opening regulatory asset base. Grid Australia support the AER having this discretion.²⁷³ Jemena suggest that forecast expenditure should be the default approach.²⁷⁴

Stakeholders broadly support the Commission's approach for dealing with capitalised related party margins and capitalisation policy changes.²⁷⁵

9.4 Analysis

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

9.4.1 Overall approach

The capex incentive objective

The Commission maintains that the capex incentive objective in the draft rule is appropriate. The ENA's comment that the objective requires the AER to ensure that "no more than" efficient costs are recovered which is inconsistent with the RPP to provide a reasonable opportunity to recover at least efficient costs does not take into account that the objective is a goal that the NER aims to achieve and not a requirement.²⁷⁶ Further, the RPPs themselves are not requirements but matters that have to be considered by

²⁶⁹ See, for example, Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 3; Origin, Draft Rule Determination submission, 4 October 2012, p. 1.

²⁷⁰ IPART, Draft Rule Determination submission, 2 October 2012, pp. 1-4; MEU, Draft Rule Determination submission, 4 October 2012, pp. 4, 21-23; SA Minister for Mineral Resources and Energy, Draft Rule Determination submission, 15 October 2012, pp. 1-2.

²⁷¹ EUAA, Draft Rule Determination submission, 3 October 2012, pp. 13-14; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 13-14.

²⁷² Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 13-14.

²⁷³ Grid Australia, Draft Rule Determination submission, 4 October 2012, p. 10.

²⁷⁴ Jemena, Draft Rule Determination submission, 4 October 2012, p. 20.

²⁷⁵ See, for example, Id., p. 15; ENA, Draft Rule Determination submission, 4 October 2012, p. 63.

²⁷⁶ ENA, Draft Rule Determination submission, 4 October 2012, p. 51-52.

the AER in making a regulatory determination. There are a number of principles which for some matters have to be weighed up because they suggest weight be given to some factors that may be in conflict.

Content of the capex incentive guidelines

As identified in section 9.2.2 the Commission's general approach is to provide the AER with discretion as to the tools that it should use to provide for appropriate capex incentives and how it uses these tools. This allows the AER to tailor incentives to individual NSPs and adjust them over time. Requiring the AER to set out the criteria that it would use to select the mechanisms it would apply to each NSP as put forward in submissions by NSP would reduce the flexibility inherent in the proposed approach.²⁷⁷ For example, it could inappropriately restrain the AER from applying or not applying particular mechanisms to particular NSPs at the time of a determination. That said, the AER could elect to provide criteria in the guidelines if it wished to do so.

The process of applying the capex incentive guidelines

The Commission considers that the existing approach to the application of incentive schemes in Chapter 6 of the NER is appropriate for the application of capex sharing schemes and the AER's decision on whether depreciation should be calculated using actual or forecast expenditure for establishing the opening RAB. That is:

- the AER would set out its proposed approach at the framework and approach stage;
- the AER could change its approach during the regulatory determination process; and
- the NSP may propose a different approach during the regulatory determination process.

This will enable a different approach to be adopted if, during the regulatory determination process, it becomes apparent that another approach is more optimal. For example, the AER might want to change its approach to the application of any capex sharing scheme after having received and assessed a NSPs regulatory proposal. Similarly, a NSP may want to propose a different approach in developing its regulatory proposal. However, in general the Commission expects that the application of these aspects of the capex incentive guidelines will be determined at the framework and approach stage in practice. The Commission therefore does not support the position of SA Power Networks, CitiPower and Powercor that the AER should be required to make a final decision on the application of any capex sharing schemes and depreciation at the framework and approach paper stage.²⁷⁸

²⁷⁷ Id., p. 52.

²⁷⁸ SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 21.

The AER would decide at the time of a regulatory determination on whether to reduce the amount of capex to go into the RAB as a result of a review of the efficiency of past capex. This is discussed in more detail in section 9.4.3.

9.4.2 Capex sharing schemes

The Commission maintains that providing principles that require the AER to consider the need for a continuous and symmetrical incentive in developing a capex sharing scheme could discourage some schemes which are appropriate. This is particularly relevant when considering the capex regime as a whole. For example, the AER might want to adjust the strength of the incentive in certain years of the period to account for possible incentives regarding the timing of expenditure as a result of only allowing the AER to reduce the amount of capex to go into the RAB for inefficient expenditure above the allowance.

If an asymmetric capex sharing scheme is applied, NSPs consider that they should be able to receive compensation through the building block revenue allowance. They suggest that guaranteed service level payments are an example of this approach which provides a positive incentive for NSPs while ensuring consistency with the RPP. While the Commission does not consider that compensation to a NSP through the building block revenue would generally be required for the purpose of a capex sharing scheme, it considers this is something that the AER would decide on at the time of a regulatory determination. This is consistent with the Commission's overall approach to provide the AER with discretion on how to set capex incentives. NSPs also raised this issue in relation to small scale incentive schemes, which is discussed in chapter 11.

9.4.3 Reviews of efficiency of past capex

When the AER can reduce the amount of capex to go into the RAB

As noted in section 9.3, some stakeholders suggest that the AER should be allowed to reduce the amount of capex to go into the RAB when a NSP has spent within its allowance as well as when it spends more. The point was made that just because a NSP has spent less than its allowance it does not necessarily mean that the expenditure is efficient. For example, the reduced spending could have been due to a change in external circumstances during the period. On the other hand, SP AusNet put forward that expenditure as a result of incentives under the STPIS should be carved out when determining whether a NSP has spent more than its allowance.²⁷⁹

The Commission does not consider that the review of efficiency mechanism should be broadened as suggested by stakeholders. The approach to be taken is intended to encourage the AER to develop and apply ex ante incentives to reveal the efficient level of capex (including timing of expenditure), so that the review of efficiency of past capex is a last resort option. It would not be desirable that an ex post review becomes the only or main means of ensuring efficient levels of capex. Indeed, the ability to

²⁷⁹ SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 5.

reduce the capex rolled into the RAB is intended for obvious cases of inefficiency, and not as the main means of achieving efficient levels of capex. This approach helps to encourage the development of ex ante incentives. It is also important for the ex ante allowance to have meaning, and if the review of efficiency can be used in the way suggested by these stakeholders the Commission is concerned that both the regulator and the NSP will not focus as much on setting an appropriate ex ante allowance. The ex ante allowance is important because it provides the basis for any ex ante incentives that are put in place and the prices that consumers pay.²⁸⁰

In addition, as noted earlier, the Commission considers that the ex ante allowance as a total represents a forecast of an efficient level of expenditure for the NSP and there should generally be little need for the NSP to spend above this amount in normal circumstances. In the event that external circumstances did change to the benefit of the NSP then a well-designed ex ante capex sharing scheme could provide an incentive for the NSP to be efficient. For example, a capex sharing scheme could provide financial incentives for a NSP to be efficient regardless of how much it is forecast to spend as generally the more efficiencies that are made the greater the financial reward for the NSP under such schemes. The ex ante incentive depends in part on how the AER exercises its discretion to implement a capex sharing scheme.

Similarly, the Commission does not consider it appropriate to allow for expenditure relating to incentives provided under the STPIS to be removed from the calculation of the overspending requirement in the NER. A NSP may spend more than its allowance in response to incentives provided under the STPIS and this expenditure may be efficient. However, it should be up to the AER to decide whether to take this into account. If the AER considers this is appropriate then it could set this out in the capex incentive guidelines. For example, the guidelines could set out that the AER would not reduce the amount of capex to be rolled into the RAB if overspending was the result of responding to incentives under the STPIS.

How the AER undertakes the reviews

As set out in the draft rule determination the Commission maintains that it is appropriate that the AER essentially applies the same test for efficiency as the ex ante test in the efficiency review when determining whether to reduce the amount of capex to go into the RAB. In addition, the AER will be required to only consider information that could have reasonably been available to the NSP at the time it undertook the capex.

The Commission notes concerns from some stakeholders on the practical difficulties of reviewing the efficiency of expenditure for the purposes of reducing the amount of capex to go into the RAB.²⁸¹ While there can be challenges in such a review the Commission notes that many regulators have undertaken such reviews in the past.

²⁸⁰ Even though there would be a subsequent adjustment to a NSP's revenue to reflect a decision to reduce the amount of capex to go into the RAB it would not necessarily be the same consumers who benefited from this subsequent adjustment as who paid the original charges.

²⁸¹ See, for example, EUAA, Draft Rule Determination submission, 3 October 2012, p. 13-14.

The Commission intends that if a NSP follows good practice and governance for making investment decisions it should be able to demonstrate to the AER that its capex overall is efficient and should be rolled in to the RAB. The presence of strong ex ante incentives for efficient capex could also provide the AER and customers with a relatively high level of assurance that any capex was likely to be efficiently incurred. The final rule allows the AER to develop ex ante incentives in part because the Commission expects that the use of such incentives could significantly reduce the likelihood of concerns that capex was inefficiently incurred. In this way, any reduction of capex to go into the RAB following a review of efficiency would be a relatively rare occurrence.

The Commission considers that good practice and governance would include a NSP being able to demonstrate that it had high quality processes in place to assess and make investment decisions, that it regularly reviewed future investment plans to assess whether they are still appropriate given changes in key assumptions such as demand forecasts, and that it actively sought the views of its customers about investment requirements. Bearing this overall approach in mind the Commission has set out some examples of how the AER could potentially approach undertaking the reviews of efficiency of past capex. Given that the capex incentive objective seeks to ensure that capex to go into the RAB meets the capex criteria in the NER, applying these techniques in a review of efficiency of past capex should enable this to be achieved.

By way of example, the AER could take a layered approach to undertaking the reviews. At the highest level the AER could consider the overall capex for the period under review and compare this expenditure with the expenditure incurred by other NSPs during the period. It could also consider whether capex is consistent with known changes in key factors affecting expenditure levels, such as forecasts of demand.

At the next level the AER could look at the governance arrangements of the NSP including the decision making processes and procedures that it had in place at the time the decision was made to undertake the capex. Better decision making processes for example could have resulted in better prioritisation and deferral of projects. This stage might also involve looking at the contracting processes used by the NSP - how flexible were the contracts entered into, how much contingency did they provide for?

Depending on the outcomes of the AER's assessments in the first two stages the AER could look at some individual projects to see whether any potential concerns identified in some of the governance and contracting arrangements appeared to raise concerns when applied to projects in practice. It could do this assessment for a sample of projects, bearing in mind that the AER can only reduce the RAB by an amount of any expenditure incurred above the NSP's capex allowance.

In extreme cases where the AER had found evidence of very poor governance processes and the initial sample of projects reviewed verified these concerns it may want to undertake a wider review of projects. While this wider review may not lead to any additional reduction in capex rolled in to the RAB it could provide valuable insights for the AER when reviewing a NSPs proposal for the next determination.

The Commission intends that the AER should not be limited to a bottom-up engineering assessment of individual projects to determine inefficiencies although this type of assessment would also have a potential role to play in any review. As explained above the Commission intends that the initial focus of reviews of efficiency of past capex would be on the governance processes and procedures of the NSP.

The Commission agrees with NSPs that the AER should have regard to the other capex incentives and measures that exist when considering the nature and extent of a review of efficiency.²⁸² In addition, the AER should also have regard to other factors such as the extent to which a NSP may have spent more than its allowance during previous regulatory control periods. The final rule adequately provides for this by requiring the AER to consider how all of the capex incentive tools taken together are consistent with the capex incentive objective when developing the capex incentive guidelines. This requires the AER to take a coordinated approach to capex incentives.

Capex that is precluded from the RAB that subsequently becomes used and useful

NSPs suggest that the AER need to allow for any disallowed capex to be carried forward where capex is subsequently used and useful.²⁸³ The Commission considers that determining whether capex was subsequently used and useful would be similar to optimising the RAB. As identified in the final rule determination on a rule change put forward by the MEU, the Commission does not support such a review.²⁸⁴ Amongst other things this would force the AER to take a project by project or asset by asset approach to reviews of efficiency of past capex assessments. Instead it should be an assessment of the total expenditure incurred. Having said this, the AER could take into account the extent to which it expected capex to later become used and useful in determining the amount of any reduction to capex to go into the RAB if it wished to do so. The AER should set this information out in its capex incentive guidelines.

Review of efficiency of past capex and capex undertaken previously

In its consultation paper on savings and transitional arrangements the Commission set out that the discretion for the AER to reduce the amount of capex to go into the RAB as a result of a review of efficiency of past capex would apply immediately following commencement of the final rule. That is, the AER would have the power to reduce the RAB as a result of a review of past capex as part of any regulatory determination which is made by the AER following the commencement of the final rule.²⁸⁵

282 ENA, Draft Rule Determination submission, 4 October 2012, pp. 59-60.

283 ENA, Draft Rule Determination submission, 4 October 2012, p. 60; Jemena, Draft Rule Determination submission, 4 October 2012, p. 20.

284 AEMC, *Optimisation of Regulatory Asset Base and the Continued Use of Fully Depreciated Assets*, Rule Determination, 13 September 2012.

285 AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, p. 11.

136 Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

NSPs did not support this approach. They implied that it would not be fair and reasonable and was not consistent with section 33 of schedule 2 of the NEL.²⁸⁶

The Commission considers that although NSPs should be undertaking capex in their current regulatory control periods in an efficient manner it agrees that it may not be reasonable to apply the mechanism to all capex incurred in the current regulatory period. This is because NSPs would not have known that the amount of capex to go into the RAB could be reduced as the result of an efficiency review when they undertook the capex for the whole of the current regulatory control period. Therefore NSPs may not have kept information and records that they would have if they had known that they would have been subject to a review. For example, a NSP whose next regulatory control period begins in 2015 would be subject to the possibility of having its opening RAB for the next period reduced to reflect inefficient capex incurred during its current regulatory control period (2010-2015). The NSP would not have known that it would be subject to an ex post efficiency test until the final rule commences in November 2012 and therefore may not have kept records and information on decision making for example to the level that it would have prior to then had it have known that it would be subject to a review.

An input into the consideration of the level of information and records that a NSP considers that it needs to maintain will depend on how the AER proposes to undertake the review as set out in the capex incentive guidelines. This is particularly relevant given that NSPs have no experience of the AER undertaking these types of review before. For these reasons, the Commission considers that it is appropriate that the AER should not be able to reduce the amount of capex to go into the RAB as a result of a review of efficiency of capex for capex that was incurred prior to the AER's first capex incentive guidelines being in place. However, as set out in the consultation paper on savings and transitional arrangements the Commission maintains that the final rules when made should apply to all NSPs as soon as possible.²⁸⁷ Therefore, the AER will be able to reduce the amount of capex to go into the RAB as a result of a review of efficiency of capex for capex that was incurred in the first regulatory year after commencement of the AER's first capex incentive guidelines. In addition, this change does not affect the requirement for the AER to make a statement on the efficiency of the capex to go into the RAB as part of its draft and final regulatory determination for each NSP - this provision will have immediate effect and will apply to all capex spent by the NSP during its current regulatory control period.

On the basis that rules that give effect to this approach are not needed on an ongoing basis, they are not included in the final rule and but are included in the transitional rules as discussed in chapter 12.

²⁸⁶ Energex, Draft Rule Determination submission, 4 October 2012, p. 2; Jemena, Draft Rule Determination submission, 4 October 2012, pp. 19-20; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 22-23.

²⁸⁷ AEMC, Consolidated Rule Request – Economic Regulation of Network Service Providers, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, p. 7.

The version of the guidelines that will have effect at the time the AER undertakes a review

NSPs have also commented on the version of the guidelines that the AER should be required to apply to reviews of efficiency of past capex. NSPs say the capex incentive guidelines in place at the beginning of the regulatory control period in which the capex being assessed was incurred should be applied - not those that were in place at the time it undertakes a review of efficiency. The ENA and SA Power Networks, CitiPower and Powercor make similar comments in relation to the rate of return guidelines, which are discussed in chapter 4, and related party margins, which are discussed below.

The Commission does not consider it is appropriate to provide this level of precision in the NER. This approach is inflexible and could lead to inefficient outcomes. For example, it would lock-in old versions of guidelines even where there have been improvements to the guidelines to recognise the experience of the AER in applying previous guidelines. It could also result in the AER applying different versions of the guidelines to different NSPs which could be difficult to do in practice and administratively burdensome. Further, the Commission notes that Chapter 6 of the NER provides that the AER should indicate how transitional issues are to be dealt with when it develops and changes its guidelines.²⁸⁸ The same provision will be added to Chapter 6A of the NER as part of this rule change. This is the appropriate means of dealing with any transitional issues arising from changes to the capex incentive guidelines.

9.4.4 Related party margins and capitalisation policy changes

Related party margins

The Commission maintains that the test in the draft rule for determining whether the RAB should be reduced for capitalised related party margins is appropriate. This is a specific issue pertaining to related party margins and is separate from the general review for efficiency. Among other things the trigger mechanisms are different. The AER does retain the discretion to make a reduction to what is added to the RAB and it might be expected that if a margin not on arm's length terms could otherwise be shown to be efficient the AER would consider this. The Commission's general starting point is that margins on arm's length terms are likely to be efficient. It therefore does not agree with Jemena that the test should be on the prudence and efficiency of the expenditure.²⁸⁹

ENA suggests that the AER should be required to take into account the capex incentive guidelines that are in place when the arrangements that gave rise to the margin being paid or payable by the NSP (not those that were in place at the time it undertakes a review of efficiency).²⁹⁰ Similarly, SA Power Networks, CitiPower and Powercor

²⁸⁸ NER clause 6.2.8(d).

²⁸⁹ Jemena, Draft Rule Determination submission, 4 October 2012, p. 15.

²⁹⁰ ENA, Draft Rule Determination submission, 4 October 2012, pp. 53-54.

consider that the AER should be required to apply the capex incentive guidelines in place at the beginning of the review period in relation to related party margins. As noted in section 9.4.3 the Commission considers it appropriate that the AER should apply the guidelines in place at the time of the review and that the AER has scope to consider transitional issues when revising the guidelines.²⁹¹

SA Power Networks, CitiPower and Powercor also wanted more detail as to what the AER should set out in the guidelines on its approach to determining the efficiency of related party margins.²⁹² The Commission does not consider that more detail in the NER on this issue is appropriate. It should be up to the AER to develop its approach on this issue taking account of the NEO, the RPP and the capex incentive objective.

Capitalisation policy changes

The draft rule provided that the AER could reduce the amount of capex to go into the RAB for expenditure that was capitalised and was not consistent with the NSP's capitalisation policy at the time of the regulatory determination in which the expenditure was incurred. NSPs consider the draft rule would remove the inappropriately classified expenditure from the RAB without acknowledging it as opex.²⁹³ NSPs suggest this is important because:

- actual opex is an important input into future allowances; and
- it will allow for the proper application of the efficiency benefit sharing scheme (EBSS).

The Commission agrees that actual opex is an important input into future allowances. Indeed actual opex incurred during any preceding regulatory control periods is a factor that the AER has to take into account in deciding whether it is satisfied with a NSP's opex forecast in its regulatory proposal.²⁹⁴ In principle, the Commission considers that it should be up to the AER to determine whether capitalised expenditure that is not allowed to go into the RAB should be recognised as actual opex for the purpose of setting the opex forecast for the next period. This would be determined by the AER through the regulatory determination process and will depend on the approach adopted by the AER in relation to the opex forecasts. It should also be up to the AER to adjust the allowances in the EBSS to take account of any capitalised expenditure that is not allowed to be rolled into the RAB. Again, it is appropriate that this be determined through the regulatory determination process.

The draft rule did not require the AER to set out its approach to determining whether expenditure has been capitalised consistently with the NSP's capitalisation policy in the capex incentive guidelines. This was because the Commission considered that this test did not require any further specification. In its response to the draft rule determination

²⁹¹ Ibid.

²⁹² Id., p. 25.

²⁹³ ENA, Draft Rule Determination submission, 4 October 2012, p. 63.

²⁹⁴ NER clause 6.5.6(3)(5) and 6A.6.6(e)(5).

NSPs suggest that the AER should be required to set out its approach to capitalised expenditure in the capex incentive guidelines.²⁹⁵ The Commission accepts that it is appropriate for the AER to set out its approach to assessing capitalised expenditure in the capex incentive guidelines given that this is a part of the capex incentive regime and that the capex incentive guidelines should set out the AER's overall approach to capex incentives in the guidelines.

9.5 Guidance on final rule

The final rule provides the AER with the capacity to use a range of different tools to provide assurance that the level of capex being incurred by NSPs is as efficient as reasonably possible. Given the scope of discretion being afforded to the AER, the Commission considers it helpful to provide some guidance as to how it intends the provisions of the final rule to operate.

9.5.1 Overall approach

The capex incentive objective was formulated to reflect the ex ante test for efficiency of capex that was developed by the Commission in 2006. This means that capex incentives should be designed with the aim that only capex that is efficient should be rolled into the RAB. Efficiency in this context would include trading off investment in new and replacement assets, maintenance of existing assets and other options such as demand side management.²⁹⁶ It also includes the efficient timing of capex and whether expenditure incurred reflects that which would have been incurred by a prudent NSP. The objective should not act as a mandatory requirement or a prohibition, but a source of direction for the capex incentives regime.

9.5.2 Capex sharing schemes

Process

The process of developing and applying a capex sharing scheme will be as follows:

- the AER may develop a capex sharing scheme or schemes that can be applied to any NSP. This will be set out in the guidelines, which should also explain how the scheme is consistent with the overall capex incentive objective;
- the AER must set out in the framework and approach paper for a NSP its proposed approach to applying any capex sharing scheme to the NSP;
- the NSP proposes how any applicable capex sharing scheme should apply to it in its regulatory proposal. For example, there may be elements that the NSP may propose that are discretionary in the scheme; and

²⁹⁵ ENA, Draft Rule Determination submission, 4 October 2012, p. 53.

²⁹⁶ In practice, efficiency can only be measured by comparison to other companies.

- the AER determines how any applicable capex sharing scheme will apply in its draft and final regulatory determinations for the NSP. For example, the AER could use this stage to set any incentive rate that is to be applied for a NSP.

Principles

The principles will reflect that the neutral position for a NSP achieving its regulated cost of capital is a NSP that is meeting its allowance and that broadly a NSP will be rewarded for improvements in efficiency that result in expenditure less than the allowance and penalised for expenditure more than the allowance. In this way, penalties should not be imposed on NSPs that undertake capex in an efficient manner. That is, the scheme should encourage NSPs to seek out and achieve efficiency improvements over and above those in the allowance. Those improvements should then be appropriately shared between NSPs and consumers. This means that achieving such efficiency improvements under the scheme should be expected to be net present value (NPV) positive for NSPs while also providing benefits for consumers.

While the principles will provide for rewards and penalties, and will not require that there be mathematical symmetry between those rewards and penalties. That is, NSPs should be rewarded with a set portion of any efficiency gains and should be penalised by a set portion of any efficiency losses. For example, a scheme may be designed so that where a NSP is able to undertake its capex program for a regulatory year at \$1 million less than the benchmark, 50 per cent of this saving, or \$500,000, is reflected in higher revenues. The same scheme may provide that where there is \$1 million over the benchmark, the NSP bears the cost of 30 per cent and only \$700,000 is recovered in revenues. The AER is required to explain in its guidelines how the scheme is consistent with the capex incentive objective.

The final rule requires the AER to take into account the interaction of the scheme with other incentives such as those relating to service performance, demand management and opex. For example, the AER should consider the impact of the mechanism on substitution of capex for opex. Similarly, it might want to consider adopting a higher powered scheme where it has access to extensive information on service standards. The AER must also take into account the capex objectives, and where relevant the opex objectives in the NER. These objectives include complying with regulatory obligations such as reliability and service standards.

In deciding whether to apply any scheme it has developed and the details of the scheme that should apply, the AER will also be required to take into account all of the same principles and factors that it has to take into account in designing a scheme. In addition, it will have to take into account the capex incentive objective and the relevant circumstances of the NSP. So for example, the AER could take into account the spending history of the NSP when determining whether to apply a scheme and the nature of any scheme. The final rule does not require that any scheme meet all of the factors that the AER is required to take into account, only that the AER takes into account or has regard to the factors. The Commission would expect the AER to explain how it had taken into account or had regard to the various factors. Further discussion on the intended role of objectives and factors is provided in section 5.5

The principles can accommodate different types of schemes. Examples of schemes that would be permitted by the final rule are described in Appendix A. These examples are not meant to limit the way the AER approaches setting capex incentives but to illustrate particular ways that the provisions on capex sharing schemes in the final rule could be implemented.

9.5.3 Reviews of efficiency of past capex

Reduction for inefficient expenditure

The final rule allows the AER to make a reduction in respect of any overspend in relation to the regulatory allowance for a specified period. The process requires that the AER must set out in its capex incentives guidelines how it will approach this.

The years that comprise this period will not match any one regulatory control period. This is because at the time a regulatory proposal is submitted, data on actual capex will not yet be available for every year of the current regulatory control period. This means that the years which comprise the period for analysis should be compared with the relevant regulatory allowance on a like for like basis, for example the same constant dollars and discount factor should be used. Under the current timing for the regulatory process and the extended timeframe set out in the final rule, three years of data from the current regulatory control period will be available at the time of the regulatory proposal assuming a five year regulatory control period. The final rule intends that the period that will be assessed to determine whether an overspend has occurred and reviewed for the purpose of reducing the amount of capex to go into the RAB should comprise:

- the years in the current regulatory control period for which the AER has actual capital expenditure data at the time the NSP submits its regulatory proposal. For example, years one to three of a regulatory control period where the regulatory control period is five years; and
- the last two years of the previous regulatory control period which will not previously have been the subject of a review of efficiency by the AER.

Even though the AER is likely to obtain the data for actual capex of the second last year of the current regulatory control period *during* the regulatory process, there may not be sufficient time for the AER to consider this. Therefore, the actual capex during the second last year of the regulatory control period will not be considered until the following regulatory determination.

As identified above, the AER will be required to set out the manner in which it will determine the amount of any reduction in more detail in the capex incentive guidelines. This could include considerations such as:

- the extent to which projects were evaluated against, and satisfied, the relevant regulatory test;

- the amount of any penalty already imposed on the NSP in respect of the expenditure through a capex sharing scheme, as well as whether the operation of a capex sharing scheme would reduce the likelihood of inefficient overspending. The Commission intends that a reduction to the amount of capex to go into the RAB following a review of efficiency by the AER should be a last resort measure and that primary reliance could be placed on an ex ante incentive to provide assurance that capex is incurred efficiently; and
- the effect of the use of actual rather than forecast depreciation in the RAB roll forward mechanism.

In determining whether an overspend has occurred, the allowance for each year is determined based on the AER's relevant regulatory determination that includes that particular year. Since this will include years in different regulatory control periods different regulatory determinations will be relevant for determining the overall allowance for the years being considered. The overspending requirement will be determined by comparing the capex allowance for the relevant period against total capex incurred. Any decisions relating to cost pass-throughs, capex re-openers and contingent projects are to be applied to adjust the allowance for the purposes of determining if there has been an overspend. In respect of cost pass throughs, this will mean that the AER will need to know the proportion of any cost pass through amount that represents capex, as opposed to opex. The AER may wish to use its information gathering powers to have this information provided with a cost pass-through application. The amount of any overspend determined will be the maximum amount that the AER can reduce the RAB by as a result of a review of efficiency of past capex.

The Commission notes that a NSP could in theory be penalised twice for the same inefficient expenditure if the cause of an overspend was due to capitalised related party margins and/or capitalised expenditure not in accordance with the NSPs capitalisation policy. However, it is expected that the AER would use its discretion appropriately in this circumstance. Similarly, in line with the general approach taken in this rule change, the AER could decide to not reduce the amount of capex going into a NSP's RAB if, after deducting for inefficient related party margins and capitalised expenditure not in accordance with the NSPs capitalisation policy, the NSP would have spent within its allowance. The AER could set this out in the capex incentive guidelines.

As described above, in determining whether expenditure incurred was efficient, the AER must only take into account information and analysis that the NSP could have reasonably been expected to have considered or undertaken at the time that it undertook the relevant capex. The NSP should only be judged on material reasonably available to it at the time, though this would include material available not just at the start of a project but also during it.

If for example the NSP chose the most efficient pole design in 2008 but further studies in 2010 indicated a different pole design would have been more efficient, it would depend on when the project was carried out relative to 2010 in the regulatory control period whether it may be appropriate for the AER to take into account these further

studies. As another example, in coming to a decision on whether work was undertaken efficiently the AER could only use unit costs at the time the expenditure was incurred. The AER could not take into account advancements in technology which may have reduced the unit costs of expenditure. One source of information that the AER could use is published forecasts of demand, for example the transmission annual planning report, and it would be reasonable for the AER to expect that NSPs actively and regularly reviewed capex plans based on the most up to date forecasts of demand.

The Commission considers that benchmarking information such as a comparison of actual capex incurred by NSPs during the period would violate the hindsight principle and would not be a basis on its own for the AER to reduce the RAB. However, as discussed in section 9.4.3, this information could be used as an initial sense check to give an indication as to whether further scrutiny of capex was required. In addition, benchmarking information that was available to the NSPs at the time it undertook the capex could be used by the AER for this purpose. For example, if the benchmark cost of building a particular asset at the start of a regulatory control period was \$1m but the NSP spent \$1.5m the AER could use this information to reduce the amount of capex to go into the RAB if the NSP could not provide justification why it paid more than the benchmark cost. This is because it could be expected that the NSP would have had access to this information at the time that it undertook the capex.

The AER should set out its reasons in the regulatory determination for reducing the capex that would otherwise be rolled into a NSP's RAB consequent upon a review of the efficiency of past capex. If the AER determines a capex overspend has occurred but determines not to make a reduction, the AER should also explain this in the determination in accordance with the consideration of the overall efficiency of what is rolled into the RAB. The Commission intends that if a NSP follows good practice and governance for making investment decisions it should be able to demonstrate to the AER that any capex it has incurred beyond the allowance is efficient and should be rolled in to the RAB.

The AER will not be able to make a reduction to the amount of capex to go into the RAB as a result of a review of efficiency of past capex where the capex was incurred before the commencement of the first capex incentive guidelines. Expenditure incurred in the current period in the first regulatory year after the commencement of the first capex incentive guidelines however may be subject to an efficiency review. This means that, for a NSP whose next regulatory control period commences on 1 January 2015 the AER could reduce the RAB as a result of inefficient expenditure incurred from 30 November 2013 to 31 December 2014 of the current regulatory control period assuming that the AER's capex incentive guidelines commence on 29 November 2013.²⁹⁷

²⁹⁷ However, it should be noted that the review of this expenditure would occur as part of the regulatory determination process for the subsequent regulatory control period as this is when the AER would have actual data for this period.

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

The statement on the efficiency of capex to be rolled into the RAB will be independent of the discretion to reduce the capex that is rolled into the RAB. In practice, the AER is likely to conduct these assessments together and use the review of the efficiency of the totality of the capex as part of its consideration of whether to make a reduction in respect of any overspend.

The final rule enables the AER to undertake these reviews in the manner it considers appropriate. In particular, these may be tailored to the circumstances of a particular NSP. A review may be different based on the AER's knowledge of how a particular NSP has undertaken capex in the past, for example. Alternatively, if a NSP has overspent in a particular regulatory control period the AER might choose to undertake a more extensive review than if it had underspent. The review could be based on a top down or bottom up analysis, or some combination of the two. It is expected that NSPs will include justification that past capex is efficient in their regulatory proposals.

9.5.4 Depreciation

The final rule enables the AER to choose the depreciation approach with regard to a number of principles. The principle that refers to the other incentives a NSP has to incur efficient capex is intended to prompt consideration of the totality of those incentives, including incentives outside the NER which may be specific to the NSP. This will provide a guide as to whether additional incentives are required to encourage efficient capex. For the final rule, the Commission accepts the ENA's proposal to broaden the named incentives from the STPIS to any scheme or other incentive. As well, the principle which relates to the efficiency of past capex will also provide a guide as to whether additional incentives are required.

To the extent that additional incentives are deemed appropriate, the principle requiring an examination of the substitution effects of short and long life assets is designed to assess the materiality of the potential distortionary effects of increasing the power of the incentive using depreciation by applying an actual approach. The extent that short-lived assets, such as information technology, can be physically substituted with long-lived assets, such as poles and wires, to achieve similar outcomes in network management should be considered in terms of the ability and the incentive to do so. In turn, a consideration of the benefits of such asset types is intended to address the potential strategic importance of such asset types to avoid potential distortions even if the relative size of the asset class is a small proportion of the capex program.

Substitution possibilities between opex and capex should also be considered for potential distortions as they are included in the capex factors. A consideration of capex factors is to encourage consistency with the overall capex incentive objective. Finally, the purpose of the requirement to consider the capex incentive guidelines is to promote internal consistency with the principles and approach included in the guidelines in any decision of the approach to depreciation.

9.5.5 Related party margins and capitalisation policy changes

The final rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to deal with related party margins that do not reflect margins that would have been incurred if, in the opinion of the AER, the arrangements had been on arm's length terms. It will be up to the AER to determine whether arrangements that were entered into by the NSP and a third party reflect arm's length terms. Similarly, it will be up to the AER to determine what the margin would have been if it considers the arrangements do not reflect arm's length terms. The AER will be required to set out its proposed approach to related party margins in the capex incentive guidelines. The Commission considers a flexible or NSP specific approach might be adopted to recognise that the incentive power differs in different circumstances and that the Covec model may assist the AER in developing this approach.

The capex incentive guidelines could also include providing greater clarity on what the NSP should report under the information provision relating to this issue.²⁹⁸ If NSPs do not provide the information required by the AER under the information provision relating to related party margins then the AER may be able to seek the required information through a regulatory information notice.

Similarly, the final rule allows the AER to reduce the capex that would otherwise be rolled into the RAB to reflect capitalised expenditure as a result of changes to the NSPs capitalisation policy during the regulatory control period.

The AER can reduce the capex that would otherwise be rolled into the RAB for these expenditure types regardless of whether a NSP has spent more than its capex allowance. Similarly, the amount by which the AER may reduce the capex that would otherwise be rolled into the RAB for these expenditure types is not limited to the amount of any expenditure above the allowance.

To assist the AER in exercising this discretion, the final rule requires a NSP to include in its regulatory proposal information on margins paid or expected to be paid to related parties and information on expenditure that has been capitalised by NSPs otherwise than in accordance with the capitalisation policy submitted to the AER as part of the NSP's regulatory proposal. As a corollary, the final rule requires NSPs to provide their capitalisation policy with their regulatory proposal. The AER will need this as a reference point in respect of actual expenditure at the time of the next determination. In practice, the AER could take the approach that it will approve capitalised expenditure where a NSP provides audited statements that its policy has not changed. Although not required, it could set this out in the capex incentive guidelines.

As identified in section 9.4.4 the Commission considers it appropriate that the AER should take into account disallowed capitalised expenditure when considering past opex of a NSP to determine its opex allowance. This should be considered as part of the regulatory determination process.

²⁹⁸ Final rule NER clause S6.1.1(6).

By comparison with the general review of efficiency of past capex, for the purpose of related party margins and capitalisation policy changes the AER has more discretion to consider capex where actual data isn't available.

On the other hand, the same arrangements as those for the general review of efficiency of past capex apply in terms of the capex that is subject to assessment following the commencement of the rule. That is, the AER will not be able to make a reduction to the amount of capex to go into the RAB where the capitalised related party margins or capitalised expenditure was incurred before the commencement of the first capex incentive guidelines. Expenditure incurred in the current period in the first regulatory year after the commencement of the first capex incentive guidelines however may be subject to this review.

10 Regulatory determination process

Summary

- The Commission has taken a holistic approach to address broad issues with the current regulatory determination process, with the purpose of improving the consumer engagement process, providing the AER and other stakeholders with an adequate opportunity to consider all relevant and significant material, and making NSPs more accountable.
- To this end, the following incremental changes have been made to the current process that are within the scope of the rule change request:
 - the NSP will provide a consumer-targeted overview paper with its regulatory proposal;
 - the AER will publish an issues paper outlining its preliminary key issues to assist the consumers to focus their resources;
 - the AER will hold a public forum to allow consumers and other stakeholders to engage with the AER and NSP on the regulatory proposal and issues paper;
 - the NSP will identify to the AER specific confidentiality claims in its regulatory proposal;
 - the AER will report such confidentiality claims on its website;
 - the AER will report on its website where it receives late or out-of-scope material from the NSP;
 - the timeframe for the regulatory determination process will be extended by commencing it four months earlier;
 - the time for the NSP to prepare its revised regulatory proposal will be increased;
 - a discretionary cross-submissions stage to target specific issues arising from submissions on the draft regulatory determination or revised regulatory proposal will be introduced;
 - the framework and approach paper will be made optional on particular matters that have been addressed in a previous framework and approach paper; and
 - changing the service classification and formulaic expression of the control mechanism will be based on unforeseen circumstances after the framework and approach paper has been published.

Difference between draft rule and final rule

- In the draft rule, the framework and approach stage and the regulatory determination process were to commence six months earlier than the current arrangements. The final rule further optimises this timeframe so that the framework and approach stage will be completed and the regulatory determination process will commence four months earlier than the current arrangements.
- In the draft rule, the framework and approach stage on a particular component or components would have only been triggered at the AER's discretion. The final rule allows the NSPs to also trigger the framework and approach stage on a particular component or components in addition to the AER.

10.1 Introduction

Regulatory decision-making involves thorough consideration of the regulated business' proposal.²⁹⁹ It involves providing opportunities for the regulated business and interested stakeholders, including consumers and consumer representative groups, to make submissions to the regulator.³⁰⁰ It also entails allowing reasonable time for full and thorough analysis of the submissions and the regulator's intermediate decisions.³⁰¹ To facilitate this, the NEL sets out the manner in which the AER is to perform its economic regulatory functions or powers.³⁰² In addition, the NEL specifies the processes that the AER, NSP and other stakeholders are required to follow as part of the regulatory determination process.³⁰³ A key to effective regulation is the reduction of regulatory risk by providing transparent and timely processes for regulatory determinations.³⁰⁴ Ensuring clarity around a number of procedural issues provides greater certainty to market participants, makes them more accountable to a clearly prescribed process, and reduces delays in regulatory decision making.³⁰⁵ This chapter addresses issues raised by the AER regarding the regulatory determination process, which are outlined below.

10.1.1 Regulatory determination process

To reduce regulatory error under the current regulatory determination process, all stakeholders are permitted to provide submissions at various points throughout the

²⁹⁹ This point was also made by the Commission in 2006. See AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 108.

³⁰⁰ Ibid.

³⁰¹ Ibid.

³⁰² Ibid.

³⁰³ Ibid.

³⁰⁴ Ibid.

³⁰⁵ Ibid.

process. The AER was concerned that NSPs are undermining the process by providing material that should be part of an initial or a revised regulatory proposal later in the process in the form of submissions.³⁰⁶ This does not provide other stakeholders and the AER sufficient time to scrutinise this material.

The AER proposed placing limitations on NSP submissions to address this issue. In particular, the AER proposed rules that would prevent the NSP from making a late initial or revised regulatory proposal in the form of submissions.³⁰⁷

10.1.2 Confidentiality claims

The current confidentiality arrangements were designed to balance the need for stakeholders to have access to the information upon which regulatory decisions are made and the need to protect confidential information. Without giving the appropriate protection for certain information, such disclosure could commercially harm the NSP or third parties. The AER was concerned that NSPs have been claiming that more information is confidential than is necessary. This, in turn, denies other stakeholders the opportunity to respond to, make an informed comment upon, and scrutinise, all relevant information.³⁰⁸

The AER proposed amendments to the NER which would, amongst other things, provide the AER with the discretion to give such weight as it considers appropriate to confidential information. This would apply in an initial or revised regulatory proposal, or in any submissions given to the AER.

10.1.3 Framework and approach

The framework and approach paper is specific to the distribution regulatory determination process. It provides the DNSP and other stakeholders with an opportunity to be consulted on the AER's likely approach to certain elements of the distribution regulatory determination.

The AER proposed changes to the content of the framework and approach paper, and when it may be departed from in a final regulatory determination. This would include:

- removing consultation on the application of incentives schemes in the framework and approach paper;
- allowing the AER to change the control mechanism, in addition to service classification, following the framework and approach paper; and

³⁰⁶ In this chapter, unless clearly specified, references to "regulatory proposal" are to regulatory proposals in Chapter 6 and revenue proposals in Chapter 6A. Where references to "revenue proposal" are referred to, these are revenue proposals in Chapter 6A.

³⁰⁷ AER, Rule change request, Part B, 29 September 2011, p. 89.

³⁰⁸ *Id.*, p. 90.

- changing the threshold for departing from the service classification and control mechanism in the framework and approach paper to "unforeseen circumstances".

10.1.4 Chapter structure

The remainder of this chapter is structured as follows:

- Section 10.2 summarises the Commission's position in the directions paper and draft rule determination;
- Section 10.3 summarises the submissions received in response to the Commission's draft rule determination;
- Section 10.4 provides the Commission's analysis of issues in response to submissions received on the draft rule determination; and
- Section 10.5 provides guidance on the final rule.

10.2 Directions paper and draft rule determination

10.2.1 Background

In the directions paper, the Commission set out objectives which it considered underpin the regulatory determination process:

- the AER should be given enough time to scrutinise material provided by a NSP in its initial and revised regulatory proposals. This includes providing a clear period of time to consider all relevant and significant material submitted during a regulatory determination process prior to making the final regulatory determination;
- the regulatory determination process should provide a reasonable opportunity for a NSP and other stakeholders to comment on and scrutinise material submitted by each party;
- the NSP should have sufficient time to prepare its revised regulatory proposal and should submit as much relevant information as possible in its revised regulatory proposal;
- in circumstances where a restriction is imposed on the content of the revised regulatory proposal, the NER should not permit this restriction to be circumvented through the use of submissions; and
- the regulatory determination process should encourage dialogue between the AER, the NSP and other stakeholders, particularly consumers, to establish a common understanding of the issues.

In the draft rule determination, the Commission considered that these key objectives are consistent with the AEMC's Chapter 6A rule determination. They are also consistent with the NEO as they will likely lead to more transparent and robust decision-making, and therefore increased certainty for investment in significant infrastructure for the provision of services.

In addressing the broader issues identified in the directions paper, the Commission decided in the draft rule determination to proceed with the following options:

- reporting late or out-of-scope submissions;
- commencing the regulatory determination process earlier, including extending the timeframe for the NSP to prepare its revised regulatory proposal;
- introducing a discretionary cross-submissions stage;
- requiring a mandatory issues paper from the AER and an overview paper from the NSP;
- identifying and reporting confidentiality claims in the regulatory proposal; and
- making the framework and approach paper an optional stage.³⁰⁹

These options were considered to enhance the transparent and timely processes for regulatory determinations, and increase the robustness of regulatory decision-making. They also would address the broader issue of providing all stakeholders with sufficient time and improving stakeholder engagement during the regulatory determination process.

10.2.2 Late or out-of-scope submissions

The AER characterised the problem as being that NSPs are undermining the process by providing late or out-of-scope submissions where they should have included this in their regulatory proposals, and proposed placing limitations on NSP submissions. In the directions paper, the Commission considered the AER's identification of the problem only highlighted a broader issue with the current regulatory determination process. The process is currently not providing all stakeholders with an opportunity to effectively scrutinise material provided by the NSP where the NSP submits further information later in the process. It also does not provide the AER with enough time to assess all relevant material and to make a decision. This late information is greater than was previously envisaged by the AEMC in 2006. There may be legitimate reasons for the provision of information later in the process, such as new information becoming available to the NSP or a material change in the circumstances. However, an increase in the quantity of late material has an adverse effect on the ability of interested parties to be engaged with the regulatory determination process.

³⁰⁹ It is noted that a framework and approach paper must exist for the prescribed matters, although this may well be the previous framework and approach paper if the approach set out in it remains appropriate.

In the draft rule determination, the Commission decided not to restrict the NSP's provision of material during the regulatory determination process. This was because it would create procedural fairness issues by denying the NSP a reasonable opportunity to make submissions, especially where there are legitimate reasons for making submissions. The Commission considered that restricting the NSP from making submissions in respect of the regulatory determination before it is made would create an inconsistency with sections 16 and 28ZC of the NEL. On this basis, the Commission noted that the AER retracted from its original proposal and was open to making modifications to its proposal to avoid any inconsistencies with the NEL.³¹⁰

Other regulators

The AER's problem with receiving information from the NSP which may be late, out-of-scope or voluminous is not unique. Regulators in general are subject to this as part of their regulatory decision-making processes, although there may be differences in the regulatory framework.

In one example provided in the draft rule determination, the New Zealand Commerce Commission was found by the High Court of New Zealand to only be required to have regard to submissions received in timeframes that the regulator sets.³¹¹ This was following a judicial review sought by the business against the Commerce Commission for rejecting out-of-scope and/or late submissions.³¹²

As a regulator, the AER currently has the discretion to not accept such late submissions from the NSP or any other stakeholder.³¹³ The Commission understood that the Australian Competition Tribunal has previously stated that the AER must draw a line on its engagement with a NSP or it will fail to meet the imposed deadlines.³¹⁴ The Commission encouraged the AER where appropriate to utilise its existing powers that are available for any administrative decision-maker to not accept late submissions.

Reporting on late and out-of-scope submissions

With this in mind, the Commission decided a better approach would be for the AER to report on any late or out-of-scope submissions it receives from a NSP. Making public on the AER's website details of late or out-of-scope submissions from the NSP may be an effective tool to discourage such submissions being made. The use of such a tool would increase transparency in this area in that the AER previously did not need to report that it had received a late submission. This approach may also be seen as creating a reputational risk for the NSP if it does decide to make a late or out-of-scope submission.

³¹⁰ AER, Directions Paper submission, 2 May 2012, p. 66.

³¹¹ *Wellington International Airport Limited v Commerce Commission* HC WN CIV-2011-485-1031 [21 December 2011], [278]-[293].

³¹² *Ibid.*

³¹³ ENA, Consultation Paper submission, 8 December 2011, p. 57.

³¹⁴ *Application by EnergyAustralia* [2009] ACompT 8, [257].

Other options

As noted above, part of the reason for late submissions also relates to a shortage of time in the current regulatory determination process. The Commission's proposed changes to the regulatory determination process, including commencing earlier and extending the current timeframe may assist to alleviate the problem.³¹⁵

10.2.3 Confidentiality claims in the regulatory proposal

AER's existing powers

In the directions paper and draft rule determination, the Commission considered that it is important that the probative value of as much of a NSP's initial or revised regulatory proposal as possible is able to be tested with stakeholders. There will almost always be information included as part of a NSP's initial or revised regulatory proposal which is legitimately claimed to be commercially sensitive and confidential. However, the Commission considered it unlikely that all aspects of an initial or revised regulatory proposal could legitimately be claimed to be confidential, partly because the NSP is a monopoly business and therefore does not compete directly with other businesses.

There also appears to be scope for information to be aggregated where concerns about confidentiality for more detailed aspects of information are present. On this basis, it would be expected that only relatively small parts of the initial or revised regulatory proposal should be commercially sensitive, and therefore confidential.

The NER do not explicitly permit the AER to give less weight to confidential information in an initial or revised regulatory proposal. However, there are existing AER powers under the NEL and common law to use discretion in addressing confidentiality claims in a regulatory proposal. These include:

- giving lesser weight to the information when making a decision;
- aggregating confidential information;
- publishing confidential information if the public benefit outweighs the detriment to the NSP arising as a result of the disclosure of the information; and
- seeking alternative arrangements such as limited disclosure.

The Commission considered that the AER has a broad range of tools at the AER's disposal to assist it in addressing confidentiality claims. The AER should take advantage of its existing discretionary powers.

³¹⁵ Commencing the regulatory determination process earlier and extending the current timeframe are described in section 10.2.6 of this final rule determination .

¹⁵⁴ Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

Limited timeframe

In the draft rule determination, the Commission considered that an additional six months to the current timeframe as discussed in section 10.2.6 should allow the AER more time to consider confidentiality claims in a regulatory proposal. However, the AER considered that extending the timeframe would not address the problem of a NSP making blanket and unsubstantiated confidentiality claims.³¹⁶ Therefore, having more information about the reasons for a confidentiality claim may make it easier for the AER to assess the claim. Categories of confidential information, as described below, may assist this.

Categorisation of confidentiality claims and guidelines

In commenting on the directions paper, NSPs proposed a categorisation of confidentiality claims to assist the AER in assessing confidentiality claims.³¹⁷ The Commission considered in the draft rule determination that these confidentiality categories are clearly legitimate reasons for claiming confidentiality as they relate to commercial sensitivities, protection of security, or privacy. However, they should not be considered an exhaustive list, which legislation would still require the AER to protect from being disclosed.³¹⁸

Therefore, the Commission proposed to require the AER to develop and consult on guidelines, which would specify the manner in which the NSP can make confidentiality claims in its regulatory proposal. This may include: categories of confidential information; and how the NSP should identify the confidential information. However, the NSP would not be prevented from making confidentiality claims. The guidelines' purpose is to assist the AER when it receives confidentiality claims from the NSP.

Further, by establishing guidelines which clarify the manner in which NSPs are to make their confidentiality claims: NSPs would have a better understanding of the AER's requirements; NSPs would become more accountable when they make confidentiality claims in regulatory proposals; and the administrative burden on the AER would be eased in addressing confidentiality claims.

In addition to the guidelines, the draft rule required the AER to publish on its website information relating to the proportion of the NSP's material that is subject to a claim of confidentiality. This would allow the public to have an understanding as to the proportion of material that has been claimed to be confidential, as well as a comparison of the proportion of material to other NSPs' claims of confidentiality.

Interaction with interested parties

NSPs proposed in their submissions on the directions paper for a non-rule based solution to the issues raised in respect of confidential information in the form of a

³¹⁶ AER, Directions Paper submission, 2 May 2012, p. 71.

³¹⁷ ENA, Directions Paper submission, 16 April 2012, p. 71.

³¹⁸ *Competition and Consumer Act 2010* (Cth) s. 44AAF.

confidential information protocol.³¹⁹ In the draft rule determination, the Commission indicated its support for any initiative that aims to improve stakeholder engagement, without the need for prescription in the NER.

With the introduction of the NSP overview paper, discussed below, the Commission considered that this would be the appropriate place to require the NSP to explain whether and, if so, how it has engaged with consumers. This would assist the AER to determine whether it should take a stricter approach in assessing the confidentiality claims from the NSP and how much weight to place on the document.

It would also encourage NSPs to become more disciplined in only making genuine confidentiality claims, clearly identify confidential information to the AER, and reduce the administrative burden on the AER. Other stakeholders would also benefit from a more transparent process and have a greater opportunity to access relevant information. Overall, this would facilitate as much testing and scrutiny of the initial or revised regulatory proposal as possible, while upholding legitimate claims of confidentiality by NSPs. This would lead to a more well-balanced and robust decision-making process.

10.2.4 Mandatory issues paper and overview paper

Issues paper

Consumer representative groups sought in submissions on the rule change request for better opportunities to be engaged in the regulatory determination process. In the directions paper, the Commission identified a need for improvement in engaging with stakeholders during the regulatory determination process, especially with consumer representative groups. This was consistent with the LMR Panel's view that there are weaknesses in the regulatory determination process for consumer and user participation.³²⁰

Therefore, the Commission considered establishing a mandatory issues paper during the time between the regulatory proposal and close of submissions on the regulatory proposal. This was seen to be for the benefit of stakeholders, including consumer representative groups.

The Commission considered in the draft rule determination that the identification of these preliminary issues would assist all stakeholders to make better use of their resources to focus on particular matters when preparing their submissions on the regulatory proposal. It would also encourage further discussion on these issues earlier in the process and before the publication of the draft regulatory determination. The regulator should also benefit from this process because fundamental differences could be identified and resolved earlier in the regulatory determination process and the quality of submissions should improve. This should lead to an overall improvement in

³¹⁹ ENA, Directions Paper submission, 16 April 2012, p. 70.

³²⁰ LMR Panel, *Review of the Limited Merits Review Regime*, Stage One Report, Report for the SCER, 29 June 2012, p. 45.

stakeholder engagement. For these reasons, the Commission endorsed the mandatory use of an issues paper.

Although optional under the NER, it was acknowledged that the issues paper has never been utilised in practice.³²¹ This is possibly due to the current limited timeframe between the regulatory proposal and close of submissions on the regulatory proposal. Additional time was therefore provided to the AER to prepare this paper. Using the ESCV's regulatory process as an example, the Commission considered that the AER should be given 40 business days after the submission of the regulatory proposal to make the issues paper.

Overview paper

In the draft rule determination, the Commission also considered the need for the NSP's regulatory proposal to be easier for consumers, including consumer representative groups, to understand. To promote this, the Commission decided that an overview paper should be provided by the NSP. The paper would be subject to preliminary examination together with the regulatory proposal.

The resource intensive nature of the regulatory determination process, especially the volume of information accompanying regulatory proposals and submissions, was recognised. A further burden is placed on resources for consumer representative groups to digest this information and understand the risks, benefits and impacts.

The overview paper would aim to address this by providing a summary of the NSP's regulatory proposal from the NSP's perspective which is specifically directed at electricity consumers. The scope would be to focus on the risks and benefits of the regulatory proposal for electricity consumers. In addition, the paper would outline how the NSP has engaged with consumers and how it has addressed any of their concerns which have been identified as a result of that engagement. Finally, a comparison between the NSP's proposed and current revenue requirements would be made. This was aimed at promoting NSP engagement with electricity consumers earlier in the process. As the NSP overview paper would be consumer-focused, it would need to be presented in plain language that would be easily understood by electricity consumers. Designing the overview paper this way would help to promote better engagement by the NSP with consumers, including consumer representative groups. It would also mitigate the disadvantage of limited consumer resources and expertise in the area. This approach would also be consistent with the LMR Panel's Stage One Report findings to encourage earlier consideration of consumers' interests in the regulatory determination process.³²²

Public forum

The Commission considered in the draft rule determination that the requirement to have an overview paper and issues paper should be complemented by a public forum.

³²¹ NER clauses 6.9.3(b) and 6A.11.3(b).

³²² LMR Panel, *Review of the Limited Merits Review Regime, Stage One Report*, Report for the SCER, 29 June 2012, p. 46.

The benefit of this is that it provides an additional opportunity for stakeholders to seek clarification from the AER and NSP on the NSP's regulatory proposal and the AER's preliminary thinking in the issues paper. Further, the forum should assist stakeholders when they prepare their submissions.

Taken together, the AER issues paper, NSP overview paper and associated public forum should improve the level of understanding of the issues and quality of input from stakeholders. These processes add value by assisting stakeholders to allocate their resources to focus on key issues in the regulatory proposal and on the AER's preliminary views.

Notwithstanding the mandatory public forum, the Commission welcomed any other informal engagement between the NSP and AER with stakeholders.

10.2.5 Cross-submission stage

The AER expressed a concern that NSPs are providing submissions on the draft regulatory determination to which other stakeholders do not have a reasonable opportunity to respond. Equally, it could be argued that other stakeholders may raise issues in their submissions which do not allow the NSP to have a formal opportunity to respond. Presently, under the NER, there are no formal consultation processes available following close of submissions on the draft regulatory determination. That said, the Commission noted in the draft rule determination that the AER has used its discretion at times to consult informally with interested parties prior to making a final regulatory determination.

In the draft rule determination, the Commission considered a formal discretionary cross-submissions process to alleviate problems associated with stakeholders not receiving a reasonable opportunity to respond to an NSP submission, and vice versa. The New Zealand Commerce Commission's cross-submissions stage was examined. It was recognised that this is a discretionary stage in which the Commerce Commission can decide to initiate the process based on a narrow scope of issues raised during the initial round of submissions.³²³

The Commission considered the AER's concerns that such a stage could create an additional administrative burden on the AER to consider an additional volume of

³²³ For example, the Commerce Commission allowed for a cross-submissions stage on its process and issues paper in one of its regulatory process with respect to input methodologies for default price-quality paths with respect to electricity distribution and gas pipeline services. This stage followed immediately after close of submissions on the process and issues paper. Later in that same regulatory process, the Commerce Commission allowed for another cross-submissions stage on its draft input methodology. This second cross-submissions stage occurred immediately after close of submissions on the draft input methodology. NSPs support a cross-submissions stage on the basis that this would provide an opportunity for submissions made by different stakeholders to be tested, and lead to a broader debate between the NSP and other stakeholders. For further information, see New Zealand Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths*, Process and Issues Paper, 9 December 2011, pp. 5, 7, 9, 12, 16; New Zealand Commerce Commission, *Draft Input Methodologies for Default Price-Quality Paths*, Consultation Paper, 15 June 2012, p. 5.

material as a result of the process, and may disincentivise the NSP from providing a complete revised regulatory proposal and submissions upfront within the current timeframes.³²⁴ These could be mitigated by giving the regulator the discretion to initiate the cross-submissions stage, and limiting the scope of the cross-submissions stage to specified matters that have been raised during first round submissions. It would also give the AER the option to dispense with the process if it considers that it would be unnecessary and to better utilise resources in preparing the final regulatory determination.

Overall, the Commission was of the view that providing the NSP and other stakeholders with an opportunity to respond to each other's submissions on specified matters would likely increase the opportunity for all to comment. It would also likely potentially reduce the volume of material that may have otherwise been provided later in the regulatory determination process, which would have been outside of the consultation period. The AER may also benefit in the cross-submissions stage if the cross-submissions provide clarity to the AER on specified matters that were raised in submissions on the draft regulatory determination.

10.2.6 Timing of the regulatory determination process

In the draft rule determination, the Commission noted that the environment for economic regulation of network services has changed since the Chapter 6A rule determination and 11 months for the regulatory determination process appeared to be inadequate. Further, it was recognised that the new additions to the regulatory determination process in the draft rule would require consequential changes to the existing 11-month timeframe.

In addition, the Commission considered extending the time for the NSP to account for a lack of resources over the Christmas to New Year period that was not previously envisaged in 2006. Nevertheless, the Commission pointed out that the NSP should not circumvent the existing requirements by submitting its revised regulatory proposals late.

The Commission decided to allow for an additional 15 business days to the current 30 business day period in which the NSP must submit its revised regulatory proposal and calibration of the timeframes to address the Christmas to New Year period problem.³²⁵ This should provide the NSP with a more reasonable opportunity to prepare and submit a complete revised regulatory proposal.

In the draft rule determination, a total 120 business days, or approximately six months, was added to the existing overall regulatory determination process timeframe. This was to account for the extension in time for existing stages in the process and the addition of new stages. The Commission did not contemplate a shorter additional amount of time as proposed in submissions because it was concerned that this would

³²⁴ AER, Directions Paper submission, 2 May 2012, p. 68.

³²⁵ The Commission notes that NSPs propose an additional period of between 10 to 15 business days to prepare their revised regulatory proposals.

reduce the AER's decision-making timeframe and impact on the robustness of its decisions. As a result, a NSP would need to submit its regulatory proposal to the AER at least 19 months, instead of 13 months, before the end of the current regulatory period.

The Commission considered that the benefit of commencing the regulatory determination process earlier by six months would allow for: additional processes to promote further stakeholder engagement and transparency; more time for the existing processes, which should lead to more robust decision-making, more comprehensive and timely submissions; and reduce late material. This would outweigh the risk of less accurate and available information for forecasts.

The Commission compared the new regulatory determination process timeframe with other jurisdictions'.³²⁶ Although it was substantially longer than some, it would still be shorter than Ofgem's 24 month timeframe. Nevertheless, a distinction was made between the regulatory process in terms of the degree of prescription in Australia, and historical developments in economic regulation in Australia.³²⁷

For consistency, the Commission decided to align the regulatory determination process timeframes for transmission and distribution as part of the improvements made to the process. As a result, the proposed changes included:

- removing the deadline for the making of the draft regulatory determination for transmission where there is currently no such deadline for distribution. This would allow the AER some flexibility in making the draft regulatory determination, which may be desirable given the different individual circumstances of NSPs; and
- changing the deadline for receipt of submissions on the draft regulatory determination for transmission to be no earlier than 40 business days after the publication of the draft regulatory determination. For transmission, the reference date was set at no earlier than 45 business days after the date specified by the AER with respect to the predetermination conference on the draft regulatory determination.

Overall, the AER would still have some flexibility in adjusting the timeframe for specific milestones as it currently does, balanced with the constraint to meet the final deadline for publishing the final regulatory determination.

³²⁶ The regulators in other jurisdictions considered were IPART in New South Wales, ERA in Western Australia, Commerce Commission in New Zealand, Ontario Energy Board (OEB) in Ontario and Rhode Island Public Utilities Commission (RIPUC) in Rhode Island. For further information, see The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, p. 4.

³²⁷ Here, the regulatory determination process starts from the date when a regulatory proposal is submitted to the regulator to the date that a final regulatory determination is made by that regulator. See The Brattle Group, *Framework for assessing capex and opex forecasts as part of a "building blocks" approach to revenue/price determinations*, June 2012, paragraphs 12 and 27.

10.2.7 Framework and approach paper

Need for a framework and approach paper

In the directions paper, the Commission considered the NSPs' proposal for a new framework and approach paper to be discretionary if there are no material changes to a particular component of the framework and approach paper.³²⁸ In such a case, there would be no need to revisit such component(s), and the then existing framework and approach paper would be sufficient. This is because the consultation on that component(s) would not provide any additional benefit. As a result, the administrative costs would be reduced by making the process more efficient and flexible. In the draft rule determination, the Commission maintained this position.

The Commission considered that, as the administrative decision-maker, the AER should be responsible for deciding whether to trigger the framework and approach paper. It would be at the AER's discretion to determine how much weight should be given to the NSP's input over other stakeholders with respect to initiating a framework and approach paper. However, it would be most likely that the NSP's input would be the most relevant, given that it has the knowledge of its own network and other matters relevant to the forthcoming regulatory period.

For consistency, the framework and approach paper process would also apply to transmission.

Control mechanism - only relevant to distribution

In the directions paper, the Commission took the view that the AER may need some flexibility to adjust the control mechanism following the framework and approach paper when unforeseen circumstances occur. This was because the AER's proposal highlighted the potential mismatch in the thresholds for changing the control mechanism and the service classification following the relevant framework and approach paper for distribution. Following further clarification from the AER regarding the differences between the form of control mechanism and the formulaic expression of the control mechanism, the Commission decided to revisit this issue in the draft rule determination.³²⁹

The Commission accepted that the amount of time required for a NSP to accommodate changes to the form of control mechanism would be significant. As a result, the form of control mechanism should be fixed in the framework and approach paper. However, if the formulaic expression of the control mechanism was able to be amended, a measure of flexibility would be afforded.

³²⁸ Under the draft rule, the components will include incentive schemes, service classifications, form of the control mechanisms, formulaic expressions of the control mechanisms, dual function assets, and methodology for forecasting expenditure.

³²⁹ Examples of the form of control mechanism can be found under clause 6.2.5(b) of the NER. On the other hand, the formulaic expression of the control mechanism is the formula associated with that form of control mechanism.

The Commission considered that this would provide sufficient flexibility in being able to change the formulaic expression of the control mechanism during the regulatory determination process, balanced with certainty in fixing the form of the control mechanism at the framework and approach paper stage. In addition, the formulaic expression of the control mechanism could be changed if the service classification is changed, addressing the AER's concern.

Threshold for changing service classification and formulaic expression of the control mechanism in regulatory determinations - only relevant to distribution

In respect of changes to service classification, the Commission maintained in the directions paper and draft rule determination that the threshold to allow the AER to depart from its framework and approach paper will be in the event of unforeseen circumstances.

The terms "good reasons" and "persuasive evidence" were seen to be unclear and ambiguous, open to differing interpretations, and create unnecessary uncertainty in the process. On the other hand, the threshold of "unforeseen circumstances" was considered to be more definitive, consistent with other parts of the NER, providing a degree of certainty compared to the "good reasons" and "persuasive evidence" thresholds, and allowing the AER some flexibility where "unforeseen circumstances" arise.³³⁰ The "unforeseen circumstances" threshold would not allow for changes due to reasons which ought to reasonably have been considered at the time that the decision was made in the framework and approach paper.

In addition, the Commission in the directions paper and draft rule determination held that the threshold for departing from the service classification should be the same as that for departing from the formulaic expression of a control mechanism. This suggested an "unforeseen circumstances" test for the formulaic expression of the control mechanism as well.

10.3 Submissions on draft rule determination

10.3.1 Regulatory determination process

The AER, MEU, EnergyAustralia and NSPs generally support the proposed changes to the overall regulatory determination process, including commencing the process earlier, the requirement for an overview paper and issues paper, allowing NSPs more time to submit their revised regulatory proposals, and a cross-submissions stage.³³¹

³³⁰ For example, the term "unforeseen circumstances" appears under NER rule 3.7A(p)(3) and clause 11.30.2(I)(3). In addition to this, the term "unforeseen" appears under clauses 5.6.2A(b)(7), 5.6.5C(a)(1), 5.6.5C(b), 5.6.5C(c), and S8.11.1(b).

³³¹ AER, Draft Rule Determination submission, 5 October 2012, pp. 17-18; ENA, Draft Rule Determination submission, 4 October 2012, pp. 3-4; EnergyAustralia, Draft Rule Determination submission, 15 October 2012, pp. 2-3; Jemena, Draft Rule Determination submission, 4 October 2012, p. 9; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4

They consider that this should provide for greater consultation and improve consumer engagement.³³² On the other hand, ESAA suggests that NSPs need to understand how the AER intends to evaluate NSPs' evidence on how they engaged with consumers, and recover their costs for consulting with consumers.³³³

Consumer representative groups consider the changes may address some concerns and better inform consumers.³³⁴ Requiring NSPs to report on customer engagement and having the AER take this into account may be meaningful if it is equivalent to the negotiated settlements approach used in some states and provinces of the United States of America and Canada.³³⁵ However, they consider that if this is not the case, then these changes will not improve consumer engagement as they would not be empowered to materially influence the outcomes of the process.³³⁶ The additional stages may create an administrative burden for consumer representative groups with limited resources.³³⁷ The Victorian DPI also expressed similar concerns with respect to the administrative burden placed on the AER and stakeholders as a result of an extended timeframe, suggesting that the overall process could be shortened (eg 12 months for the ESCV) as it has been previously done in other jurisdictions.³³⁸

NSPs propose further improvements to the process.³³⁹ These include: reinstating submission guidelines for transmission as without this TNSPs would be subject to an administrative burden in changing to the new requirements; separating the deadline for NSP revised regulatory proposals and submissions on the draft regulatory determination from the deadline for stakeholder submissions on the draft regulatory determination, NSP's submission and revised regulatory proposal; and commencing the regulatory determination process in a shorter period than the extended six months to avoid issues of inaccurate and irrelevant information (such as forecasts) in regulatory proposals.³⁴⁰

October 2012, p. 30; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 6; MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

332 AER, Draft Rule Determination submission, 5 October 2012, pp. 17-18; ENA, Draft Rule Determination submission, 4 October 2012, pp. 3-4; Jemena, Draft Rule Determination submission, 4 October 2012, p. 9; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, p. 30; SP AusNet, Draft Rule Determination submission, 4 October 2012, p. 6; MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

333 ESAA, Draft Rule Determination submission, 23 October 2012, p. 3.

334 ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 16-17.

335 Ibid.

336 Ibid.

337 MEU, Draft Rule Determination submission, 4 October 2012, pp. 27-28.

338 Victorian DPI, Draft Rule Determination submission, 2 November 2012, pp. 3-4.

339 ENA, Draft Rule Determination submission, 4 October 2012, pp. 66-68; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 6-7.

340 Ibid.

Other more specific issues related to the discretionary cross-submissions stage occurring after submissions on the revised regulatory proposal closes (if any). The AER supported being given the discretion to trigger this stage on specific issues that may not have been subject to consultation.³⁴¹ However, the NSPs did not consider that the stage should be discretionary because the AER may not be in a position to identify the significant issues and the NSPs may not have an opportunity to comment on them if the stage is not mandatory.³⁴² They consider that there is sufficient constraint on the NSPs to not provide out-of-scope submissions; even so, a more appropriate constraint on the cross-submissions stage would be to limit the scope of submissions made during the cross-submissions stage, rather than giving the AER discretion to trigger the stage.³⁴³ Alternatively, the cross-submissions stage should be made mandatory if the AER uses its discretion to invite submissions on the revised regulatory proposal.³⁴⁴

The NSPs also propose for the final regulatory determination to be completed earlier and to increase the period for submitting the DNSPs' pricing proposals.³⁴⁵ IPART supports this approach, noting that a rule change request has been submitted to the Commission to address the annual pricing proposal framework.³⁴⁶

10.3.2 Confidentiality claims

The AER regards the confidentiality guidelines as a way in which it may outline to the NSP what is required when NSPs make confidentiality claims in their regulatory proposals.³⁴⁷ Ergon Energy sought further clarification that the categories of confidential information would not refer to personal affairs or personal information because this is already covered under other legislation.³⁴⁸ Although broadly supporting the Commission's approach, the Consumer Action Law Centre considers that more can be done to improve the way in which consumer representative groups are engaged with respect to confidential information such as developing protocols.³⁴⁹ On the other hand, Origin considers that there will be no reduction in confidentiality claims in regulatory proposals and seeks more stringent requirements.³⁵⁰

³⁴¹ AER, Draft Rule Determination submission, 5 October 2012, p. 18.

³⁴² ENA, Draft Rule Determination submission, 4 October 2012, p. 67; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 30-31.

³⁴³ Ibid.

³⁴⁴ Ibid.

³⁴⁵ ENA, Draft Rule Determination submission, 4 October 2012, p. 68.

³⁴⁶ IPART, Draft Rule Determination submission, 2 October 2012, pp. 1, 4-5.

³⁴⁷ AER, Draft Rule Determination submission, 5 October 2012, p. 18.

³⁴⁸ Ergon Energy, Draft Rule Determination submission, 7 October 2012, p. 9.

³⁴⁹ Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4.

³⁵⁰ Origin, Draft Rule Determination submission, 4 October 2012, p. 2.

10.3.3 Framework and approach

Need for a framework and approach paper

The AER supports the optional framework and approach stage to apply to distribution and transmission.³⁵¹ However, the NSPs consider that this stage should be mandatory because: the AER is being given the sole discretion to trigger the stage without equal input from NSPs; the need for NSPs to prepare for new components or changes to existing components in the framework and approach paper, especially with the expanded scope of the framework and approach; and simplicity of drafting.³⁵² On the other hand, NSPs would accept an optional framework and approach stage if they were given equal discretion as the AER to trigger the stage, while third party stakeholders can also submit on whether they consider a framework and approach stage is necessary.³⁵³ TNSPs also object to the new requirement for a framework and approach stage in transmission as they consider harmonising the historical differences in forms of regulation and price control for standard control services is unique to distribution, and transmission is already mature and homogenous enough without the need for a framework and approach stage.³⁵⁴

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

NSPs maintain their position that the threshold for changing service classification and the formulaic expression of the control mechanism in regulatory determinations should be based on new evidence becoming available after the framework and approach stage which would justify departure from that stage ie persuasive evidence.³⁵⁵ They provide examples where it would be foreseeable, yet would justify a departure, such as: competition in the provision of alternative control services being foreseeable but its impact on the market not being crystallised until after the framework and approach stage; and a contingent project trigger event occurring which would be foreseeable and require a change in the service classification.³⁵⁶

10.4 Analysis

As in the draft rule determination, the Commission's general approach to this rule change request has been to provide the AER with more discretion. Unlike rate of return or capex incentives, however, in respect of the regulatory determination process there are less risks of additional prescription in the NER. In particular, there should be less need for regular changes to the regulatory determination process to adapt to changing

351 AER, Draft Rule Determination submission, 5 October 2012, p. 18.

352 ENA, Draft Rule Determination submission, 4 October 2012, pp. 8, 73-74.

353 Ibid.

354 Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12-13.

355 ENA, Draft Rule Determination submission, 4 October 2012, pp. 74-75.

356 Ibid.

circumstances. To allow stakeholders to properly plan, certainty is also very important for the regulatory determination process.

Nonetheless, the current NER or final rule does not prescribe the regulatory determination process on every aspect, and the AER does have discretion in many respects. This discretion may include further consultation when the AER proposes a shift from its draft position, and placing less weight on, or not considering, information that is submitted too late in the process.³⁵⁷ Further, the NER only provide a framework towards effective engagement; it should be seen as a minimum in terms of the level of engagement. The extent of interaction between the NSP, the AER and other stakeholders is up to those parties. For instance, the AER and NSP should be engaging with each other regularly on an informal basis, including outside of the regulatory determination process. NSPs can, and should, be engaging with consumers and other stakeholders in their network areas outside of the process as well.

As a general rule, the Commission will not be prescribing in the NER requirements where a regulatory requirement already exists via the NEL or common law. The Commission considers that giving the AER discretions, which are a general function of regulators or are already set out in the NEL, should be avoided where possible. This is especially so where it is clear that they would still exist in the absence of the NER and including them in the NER would not provide any additional value. This general approach avoids any potential conflict between the NER and the NEL or common law, especially if the NEL or common law position were to change in the future.

10.4.1 Regulatory determination process

Consumer engagement

The Commission notes the consumer representative groups' dissatisfaction with the draft rule changes made to the regulatory determination process to meet their need for empowerment in influencing the outcomes of the process.³⁵⁸ The changes in the draft determination were intended to improve transparency and accountability, increase consultation and therefore scrutiny of information submitted during the process, and provide for more robust decision-making within the scope of the rule change. The Commission does not purport to address larger consumer related issues such as lack of resources, expertise or funding which is, as a number of consumer representatives point out, a role for the policy maker.³⁵⁹ For instance, the Commission has

³⁵⁷ It is noted that section 16(b)(l) of the NEL requires the AER to inform the NSP of material issues under consideration by the AER.

³⁵⁸ ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 16-17.

³⁵⁹ Ibid.

recommended to the SCER the creation of a national peak consumer body.³⁶⁰ However, where possible, the Commission will be endeavouring to improve the operation of the rules to assist consumers to be better engaged. The Commission notes that this has not been opposed by any stakeholder throughout the process, but rather has been fully accepted as a given. Therefore, amongst other changes, improving the regulatory determination process will be for the benefit of all parties, especially consumer representative groups, in requiring NSPs to submit overview papers, requiring the AER to publish issues papers, holding mandatory public forums, extending time for consultation, and providing for a discretionary cross-submissions stage. As the Commission noted in its draft rule determination, though, the regulatory determination process only provides a minimum framework in which the AER and NSPs can engage with each other as well as with other stakeholders such as consumers. In the end, it is up to all parties involved to engage in good faith, which the NER cannot prescribe.

With respect to the consumer representative groups' preferred negotiated settlements approach, the scope for full negotiated settlements between consumers and NSPs is beyond what the Commission could reasonably consider being within scope for this rule change process.³⁶¹ Instead, changes to effect the consumer representative groups' preferred approach are better addressed outside of this rule change process as part of the broader development of a stronger consumer role. This rule change process can be considered as part of this broader development.

Commencement of the regulatory determination process

The Commission notes the concerns expressed by some NSPs that the earlier the regulatory determination process commences, the less accurate and relevant the forecast expenditure and other information will be in the NSP's regulatory proposal.³⁶² The Commission maintains that improvements in the regulatory determination process will require it to commence earlier than the current arrangements. This will avoid reducing the existing length of time for the AER to prepare its draft and final regulatory determinations as it could impact on the robustness of its decision-making. However, the Commission has identified ways to further optimise the timing without necessarily impacting on the AER's time to prepare and make decisions, as well as providing NSPs and other stakeholders with sufficient opportunities to make submissions during the process.

³⁶⁰ AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 155.

³⁶¹ ATA, Draft Rule Determination submission, 4 October 2012, pp. 3-6, 8; Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4; Ethnic Communities' Council of NSW, Draft Rule Determination submission, 4 October 2012, pp. 2-3; EUAA, Draft Rule Determination submission, 3 October 2012, pp. 4, 16-18; UnitingCare Australia, Draft Rule Determination submission, 16 October 2012, pp. 5, 17.

³⁶² ENA, Draft Rule Determination submission, 4 October 2012, pp. 66-68; Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14; SP AusNet, Draft Rule Determination submission, 4 October 2012, pp. 6-7.

A minor reduction will be made to the timeframe so that stakeholders now have 30 business days (instead of 60 business days under the draft rule) after the publication of the issues paper to make a submission on the regulatory proposal and issues paper. This means there will be an overall timeframe of 70 business days for submissions to be made on the regulatory proposal (as opposed to 100 business days under the draft rule). The public forum will also be 10 business days after the issues paper is published (as opposed to 20 business days under the draft rule), while the time between the public forum and close of first round submissions will be 20 business days. Nevertheless, the overall timeframe will still be greater than the existing arrangements.

With respect to the NSPs' proposal to create two separate stages for submissions on the draft regulatory determination, the Commission considers that this is not necessary, given that the cross-submissions stage may be triggered by the AER to address specific issues raised in submissions that it considers further consultation is required.³⁶³ In addition, the AER has the discretion to choose the time by which stakeholders must make a submission on the draft regulatory determination and revised regulatory proposal, which can be after the date when the revised regulatory proposal is submitted.

Instead of the separate steps for submissions, the Commission has decided to align the minimum timeframe for making submissions on the draft regulatory determination with the maximum timeframe for the NSP to submit its revised regulatory proposal. This will mean that, at a minimum, the deadline for submissions on the draft regulatory determination can occur at the same time as the NSP's submission of the revised regulatory proposal (if required) is due; otherwise, the AER can decide to extend the deadline for submissions on the draft regulatory determination to a time after the NSP submits its revised regulatory proposal (if required). Therefore, the proposed 40 business days for submissions on the draft regulatory determination (as specified in the draft rule) will be changed to a minimum of 45 business days. Further, the alignment between the minimum time to make submissions on the draft regulatory determination and the maximum time for NSP's submission of its revised regulatory proposal will now be consistent with the current arrangements.

As a result of these minor amendments to the extended time for the regulatory determination process, the overall timeframe will be four months earlier than the current arrangements (as opposed to six months under the draft rule). An advantage for most NSPs is that their regulatory proposals will not be due between the Christmas and New Year period. Although this may not alleviate some of the concerns from NSPs regarding inaccurate information, the consideration of this reduction has been balanced with the need for allowing the improvements to the overall regulatory determination process. Therefore, the NSP will need to submit its regulatory proposal to the AER at least 17 months, instead of 13 months, before the end of the current regulatory period.

³⁶³ Ibid.

Completion of the regulatory determination process

In terms of the NSPs' proposal for the regulatory determination process to be completed earlier to reduce the burden related to the pricing proposal process, the Commission notes that this is outside the scope of this rule change process.³⁶⁴ As noted in the IPART submission, a separate rule change request has been submitted on the annual pricing proposal framework.³⁶⁵ The Commission's Power of Choice review has also made a draft recommendation to allow sufficient time in the current annual tariff setting process for the AER to monitor DNSPs with respect to actively developing and improving their tariff structures to meet revised pricing principles as best as possible at all times.³⁶⁶ Therefore, the final rule does not address the issues associated with completing the regulatory determination process earlier. That said, the arrangements will be flexible in the sense that the final regulatory determination will be required to be completed no later than two months before the end of the regulatory control period, which will allow the AER the discretion to complete the final regulatory determination before that time.

Cross-submissions stage

The Commission notes the NSPs' concern with giving the AER discretion to trigger the cross-submissions stage with the view that this step should be mandatory and limited in scope.³⁶⁷ In developing the cross-submissions stage, the Commission took into account the New Zealand Commerce Commission's approach, which NSPs originally relied on as the basis for their proposal. The Commission considers that the reason the cross-submissions stage has been implemented with great effect in New Zealand is that it is at the discretion of the regulator to trigger that stage and the scope of it is limited according to the submissions provided from stakeholders.

Further, if the stage was mandatory, this could create another opportunity for NSPs to make late submissions. NSPs consider that this could be discouraged by limiting the scope of submissions as well as the AER's reporting of late or out-of-scope submissions.³⁶⁸ However, the Commission considers that making it a discretionary stage and limiting the scope are complementary tools which the AER can use to implement the cross-submissions stage.

The NSPs' concern that the AER may not be able to fully understand or identify the relevant significant issues can be alleviated in other ways which does not necessitate prescription of a more lenient cross-submissions stage.³⁶⁹ The Commission has stated that the regulatory determination process should be considered as a minimum

³⁶⁴ ENA, Draft Rule Determination submission, 4 October 2012, p. 68.

³⁶⁵ IPART, Draft Rule Determination submission, 2 October 2012, pp. 1, 4-5.

³⁶⁶ AEMC, *Power of choice - giving consumers options in the way they use electricity*, Draft Report, 6 September 2012, p. 109.

³⁶⁷ ENA, Draft Rule Determination submission, 4 October 2012, p. 67; SA Power Networks, CitiPower and Powercor, Draft Rule Determination submission, 4 October 2012, pp. 7, 30-31.

³⁶⁸ Ibid.

³⁶⁹ Ibid.

standard to which the AER and NSPs can engage in the process. Outside of this, NSPs and the AER should be engaging with each other informally. The need for the AER to understand the NSPs' concern as to its significant issues can therefore be addressed by informal communication between the NSP and the AER. A formal cross-submissions stage should not be seen as a substitute for good regulatory practice, including dealing with procedural fairness issues, for all of the parties involved.

Submission guidelines

As a general rule, the Commission has taken the view that where there is no substantive reason for any difference in the regulation between transmission and distribution, then there should be an alignment between the two. In examining the differences between the submission guidelines and the later arrangements under Chapter 6 which incorporate the RIN, the Commission considers that the arrangements can be better aligned. The Commission considers that applying two different instruments to achieve the same purpose is administratively inefficient and has therefore decided that it should be aligned in the form of the RIN with consequential changes to the NEL. The TNSPs' objections to replacing submission guidelines with the RIN for reasons of administrative costs and lack of benefit of alignment are outweighed by the long term benefit to customers in having a consistent regime in which the AER can regulate in a consistent manner and other stakeholders can be better engaged by following a consistent regulatory determination process.³⁷⁰

10.4.2 Confidentiality claims in the regulatory proposal

The Commission notes Origin's particular issue that the confidentiality claims will not be reduced through the draft rule.³⁷¹ As previously stated, the Commission considers that the AER currently has sufficient authority under the NEL and common law to address confidentiality claims made in regulatory proposals. The draft rule was not intended to displace those arrangements. However, additional tools will be provided to the AER in the form of confidentiality guidelines. These will include: the AER to specify the manner in which confidentiality claims to be made by NSPs in their regulatory proposals; the need for the NSP to identify their confidentiality claims; and the AER to report on confidentiality claims on its website. Together, these provide additional incentives for NSPs to be more accountable in providing genuine confidentiality claims and the AER with some tools additional to its existing powers under the NEL and common law in addressing confidentiality claims.

The Consumer Action Law Centre also claims more can be done with respect to confidentiality claims by requiring confidentiality protocols to be put in place by the NSP.³⁷² However, as the Commission stated in its draft rule determination, this is unnecessary as the NSPs and the AER could be doing this as part of its stakeholder engagement plan without the need for prescription in the NEL.

³⁷⁰ Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12, 14.

³⁷¹ Origin, Draft Rule Determination submission, 4 October 2012, p. 2.

³⁷² Consumer Action Law Centre, Draft Rule Determination submission, 5 October 2012, p. 4.

¹⁷⁰ Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

10.4.3 Framework and approach

Need for the framework and approach stage

With respect to the approach in the draft rule determination which provided the AER with the sole responsibility to trigger the framework and approach stage and not the NSP, the Commission recognises the NSPs may be in a better position at times to understand whether there should be a need for any new components or changes to existing components in the framework and approach paper. For this reason, the Commission accepts the NSPs' submission to also be able to trigger the framework and approach stage.³⁷³ This means that the NSP will need to advise the AER on whether it considers there is a need for the stage and that the NSP can trigger the stage. The difference between the steps for the AER to trigger the process compared to NSPs is that the NSP will only be required to notify the AER by a certain date, while the AER will still be required to consult on particular components not triggered by the NSP. The AER should take into account the interests of third parties such as consumers in deciding whether it will trigger the framework and approach stage.

Introduction into transmission

With respect to TNSPs' objection to the introduction of the framework and approach stage into transmission, the Commission has applied the same position as it has for distribution.³⁷⁴ For transmission, new incentive schemes and information requirements for forecast expenditure assessments will now be addressed, which will be covered in the framework and approach stage.³⁷⁵ The advantage of having a framework and approach paper for transmission is that it encourages engagement earlier in the process, especially with third parties such as consumer representatives, and therefore reduces the amount of information to be considered later in the regulatory determination process. As a result, it should increase administrative efficiency in the process. Further, as stated earlier, where there is no substantive reason for any difference in the regulation between transmission and distribution, then there should be an alignment between the two.

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

The Commission notes the ENA's examples where it considers the unforeseen circumstances test to be inappropriate eg where development of competition may be foreseeable at the time but its impact on the market is unknown, and where a contingent project trigger event occurs which would require alteration of the service classification.³⁷⁶ With the former example, if development of competition may be foreseeable at the time but its impact on the market is unknown, the impact on the market can still be regarded as unforeseeable. Otherwise if the impact on the market

³⁷³ ENA, Draft Rule Determination submission, 4 October 2012, pp. 8, 73-74.

³⁷⁴ Grid Australia, Draft Rule Determination submission, 4 October 2012, pp. 3, 12-13.

³⁷⁵ NSPs will also be required to advise the AER of their approach to expenditure forecasting.

³⁷⁶ ENA, Draft Rule Determination submission, 4 October 2012, pp. 74-75.

was foreseeable, then appropriate service classification should have been made during the framework and approach stage.

Likewise, the contingent project may be foreseeable at the time although its scope and cost is unknown, but the change in service classification can still be regarded as unforeseeable. Otherwise if the change in service classification was foreseeable, then appropriate service classification should have been made during the framework and approach stage.

For both of the above examples, the Commission notes that the AER has the responsibility to consider whether a change in circumstances was foreseeable or unforeseeable. The Commission maintains the view that the unforeseen circumstances test is adequate.

10.5 Guidance on final rule

10.5.1 Late or out-of-scope submissions

If the AER receives a late or out-of-scope submission from a NSP, the AER is required to make available on its website the following information:

- the identity of the NSP who made the late or out-of-scope submission;
- a summary of the particular information it considers to be late or out-of-scope;³⁷⁷ and
- an indication of the amount or length of that information that it considers to be late or out-of-scope.

In addition to the above, the NSP may wish to informally respond to the AER to explain its reasons for providing such a submission once it is made aware of the AER's position.

10.5.2 Confidentiality claims in the regulatory proposal

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

³⁷⁷ For instance, the summary may simply cross refer to that information as contained in the submission.

Once the guidelines are in place, the NSP is required to identify to the AER which information it claims to be confidential. This may include identifying the category of confidentiality claim that the NSP wishes to make. Based upon this information, the AER is able to determine the comparative proportion of material that has been claimed as confidential with regard to other NSPs. The AER can then report on its website that a confidentiality claim has been made. Other information on the website include:

- the identification of the NSP;
- the quantity and proportion of confidential information; and
- a comparison of the NSP's proportion of confidential information to other NSPs.

The AER will not be required to report on other more specific aspects such as categories of confidentiality claims. That type of information is more for the AER's benefit when addressing confidentiality claims.

As an example, the AER provided a table in a previous submission to demonstrate the proportion of material from NSPs that it has previously received claiming to be confidential.³⁷⁸ This is reproduced and shown in Table 10.1. The AER could use a similar format on its website to report on confidentiality claims and include the identification of the NSP and proportion of confidential information claimed from each NSP.

Table 10.1 **Page count - documents submitted by DNSPs in the AER's Victorian electricity distribution determination (2011-15)**

| | Regulatory proposal | | Revised regulatory proposal | |
|------------|---------------------|--------------|-----------------------------|--------------|
| | Public | Confidential | Public | Confidential |
| Business 1 | 1,540 | 4,584 | 4,157 | 5,599 |
| Business 2 | 2,960 | 5,231 | 9,337 | 10,235 |
| Business 3 | 1,869 | 22,811 | 1,704 | 2,626 |

Source: AER, Directions Paper submission, 2 May 2012, p. 71.

In addition to the rule for confidentiality claims with respect to initial or revised regulatory proposals, the Commission considers that the same rules could also be applied to the pricing methodologies and to submissions in general.³⁷⁹ However, no consequential amendments have been made to the NER to align confidentiality claims in respect of submissions with the Commission's position on regulatory proposals. This is because the NER provisions relating to confidentiality claims in submissions already exist. Conversely, the Commission considers it appropriate to treat confidentiality

³⁷⁸ AER, Directions Paper submission, 2 May 2012, p. 71.

³⁷⁹ Pricing methodologies are submitted with the regulatory proposal in transmission.

claims in respect of pricing methodologies for transmission consistently with confidentiality claims in respect of regulatory proposals.

10.5.3 Mandatory issues paper and overview paper

Issues paper

The Commission has decided to require the AER to publish an issues paper. The purpose of the paper is to identify the preliminary issues that the AER considers are likely to be relevant to its assessment of the NSP's regulatory proposal. However, the AER is not precluded from considering other issues when making its regulatory determination. Therefore, the issues paper is not an exhaustive review of the proposal and does not contain a complete list of the matters that the regulator would consider in making its final regulatory determination.

The issues paper is published within 40 business days of the AER receiving the NSP's regulatory proposal. It is noted that the publication date for the issues paper is not based on when a resubmitted regulatory proposal, if required to be resubmitted, is received by the AER. This is because the AER can still prepare the issues paper while it waits on further information to be included in the resubmitted regulatory proposal. Therefore, only the period between the resubmitted regulatory proposal and issues paper is affected. Besides the public forum on the issues paper, the other milestones in the regulatory determination process are not contingent on the date that the issues paper is published.

The deadline for submissions on the issues paper and regulatory proposal is required to be no earlier than 30 business days after the AER publishes its issues paper. This means that the deadline for submissions on the regulatory proposal is essentially no earlier than 70 business days after receipt of the regulatory proposal.³⁸⁰ The additional time for submissions on the regulatory proposal takes into account the introduction of the issues paper and submissions associated with that paper.

Submissions on the issues paper are due at the same time that submissions on the regulatory proposal are due. This reflects the purpose of the issues paper, which is to assist stakeholders, particularly consumers and consumer representative groups, in preparing their submissions on the regulatory proposal.

Overview paper

With a consumer-specific focus in mind, the mandatory overview paper needs to explain how the NSP has engaged with electricity consumers in preparing its regulatory proposal. The paper also provides a summary of the regulatory proposal for electricity consumers. In this way, the overview paper acts as a "map" to the regulatory proposal and helps consumers focus on the relevant parts when responding to the regulatory proposal. In addition, the paper will explain how the NSP has sought to

³⁸⁰ This time also takes into account the 40 business days for the AER to publish its issues paper after receipt of the regulatory proposal.

address any relevant concerns identified as a result of the engagement with electricity consumers. To further focus the attention of consumers, the paper will describe the key risks and benefits of the regulatory proposal for electricity consumers. Finally, the paper will compare the total revenue approved for the current regulatory period with the NSP's proposed total revenue for the next regulatory period. In this regard, the NSP is to provide an explanation for any material differences between these two amounts.

Given that consumers need to be able to easily access the paper, the overview paper is a standalone document provided with the regulatory proposal. This means that the paper is to be in plain language, that is, it must not use technical language or industry jargon.

To reflect the overview paper's importance in the process, the AER will be given the ability to accept or reject the overview paper which accompanies the regulatory proposal. If the AER considers that the overview paper does not comply with the NER requirements, the AER may reject the overview paper and require that this paper be resubmitted, addressing any relevant requirements. To provide clarity to the NSP on the information required in the overview paper, the AER can utilise a regulatory information instrument.

Public forum

The AER will be required to convene a public forum on the NSP's regulatory proposal and the AER's issues paper. This must be held within 10 business days after the AER publishes its issues paper on the NSP's regulatory proposal.

10.5.4 Cross-submissions stage

The final rule provides for a cross-submissions stage in the NER. The AER will have the discretion to decide whether or not the cross-submissions stage is required immediately following the close of submissions on the revised regulatory proposal. If the AER does not invite submissions on the revised regulatory proposal, it implies that the cross-submissions stage is unnecessary. The AER will have the discretion to limit the scope of the cross-submissions stage. The scope is limited to specified matters that have been raised during submissions on the draft regulatory determination or submissions on the revised regulatory proposal. If utilised, the cross-submissions stage allows for at least 15 business days for submissions after the invitation for submissions is published.

10.5.5 Timing of the regulatory determination process

Commencing the regulatory determination process four months earlier, as can be seen in Figure 10.3, will allow for:

- the AER to prepare and publish the issues paper within 40 business days following receipt of the NSP's regulatory proposal;

- stakeholders to submit on the issues paper and regulatory proposal no earlier than 30 business days following the publication of the issues paper;
- a public forum to be held within 10 business days after publication of the issues paper;
- the NSP to submit its revised regulatory proposal within 45 business days after the publication of the draft regulatory determination;
- other stakeholders to submit on the draft regulatory determination no earlier than 45 business days after the publication of the draft regulatory determination; and
- a cross-submissions consultation stage of no earlier than 15 business days.

Figure 10.1 and Figure 10.2 are examples of the current regulatory determination process applicable to TNSPs and DNSPs, while Figure 10.3 shows the changed process according to the final rule.

Figure 10.1 Example of the current regulatory determination process applicable to TNSPs (hypothetical dates used)

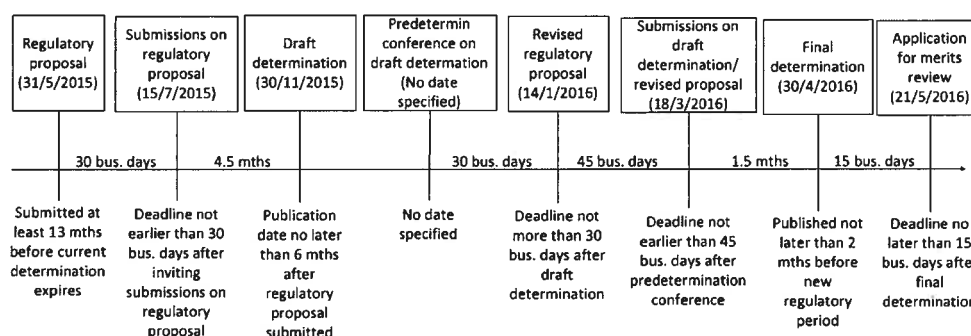
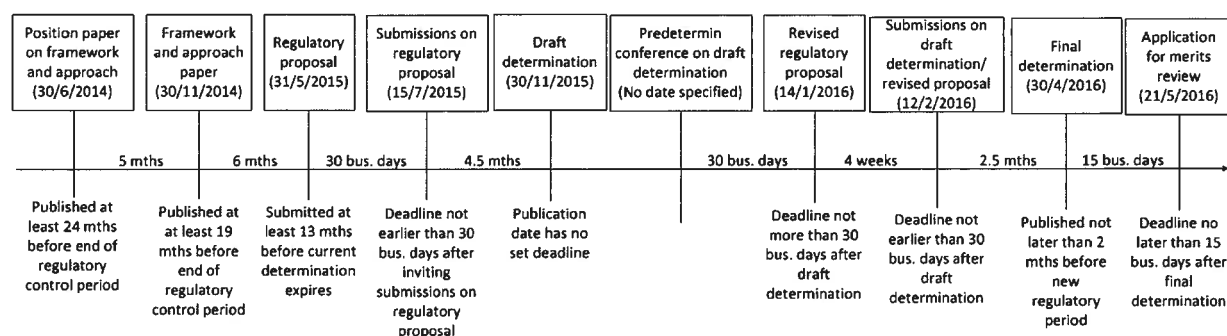
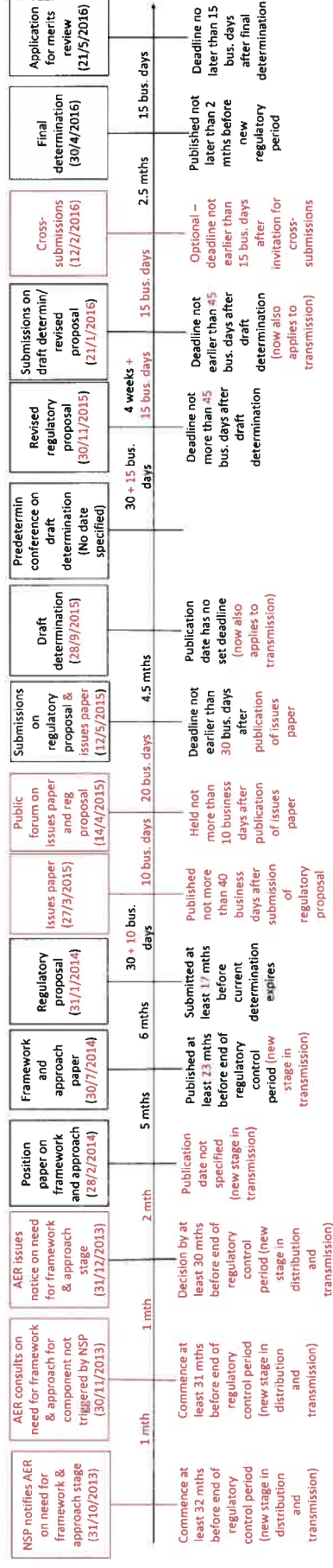


Figure 10.2 Example of the current regulatory determination process applicable to DNSPs (hypothetical dates used)



Note: the dates used in Figure 10.1 and Figure 10.2 are hypothetical and are only used to illustrate the differences between the existing timeframe in these figures and the new timeframe shown in Figure 10.3.

Figure 10.3 Example of the new regulatory determination process applicable to DNSPs and TNSPs (hypothetical dates used)



Note: the dates used in Figure 10.3 are hypothetical; changes to the current regulatory determination process are highlighted in red text.

10.5.6 Framework and approach paper

Triggering the framework and approach paper

The AER or the NSP will have the discretion to trigger the framework and approach paper stage. The circumstances in which the framework and approach stage is required are if:

- there is no previous framework and approach paper on a particular component or components; or
- the AER or NSP decide that a particular component or components from the previous framework and approach paper will be amended or replaced.

The circumstances above require that there must always be in place a framework and approach paper on a particular component or components, even if that is a previously existing framework and approach paper. A corollary of this is that, where a framework and approach paper on a particular component has previously been put in place, the requirement for a framework and approach paper on that particular component or components can be bypassed if the existing framework and approach for that component or components is still appropriate. In other words, the framework and approach paper can only be reopened for the particular components that the AER or the NSP decides should be consulted upon.

Where the AER is considering whether to trigger the framework and approach stage on a particular component or components, the AER has the responsibility to consider all stakeholder comments on whether a revised framework and approach paper is necessary to address a particular component or components. This is done prior to the AER making a decision on whether to trigger the framework and approach paper stage. This gives relevant stakeholders an opportunity to make a submission to the AER. It also promotes transparency in the process. Alternatively, the AER may not receive any submissions on triggering a framework and approach paper on a particular component or the NSP may not trigger a framework and approach paper on a particular component or components, but the AER can still decide to trigger the stage.

To this end, if the AER is deciding whether to trigger the framework and approach stage on a particular component or components, then the AER must:

1. issue an invitation for comment by at least 31 months before the end of the current regulatory period;
2. issue a notice on whether it will trigger the framework and approach stage by at least 30 months before the end of the current regulatory period;
3. then commence consultation on the framework and approach paper on that particular component or components; and

4. have completed and published the framework and approach paper by at least 23 months prior to the end of the current regulatory period.

Alternatively, if the NSP decides to trigger the framework and approach stage on a particular component or components:

1. the NSP is required to notify the AER at least 32 months before the end of the current regulatory period on which particular component or components that should be triggered in the framework and approach stage;
2. the AER must issue an invitation for comment on other components that are not covered by the NSP request by at least 31 months before the end of the current regulatory period;
3. the AER must issue a notice on the NSP's requested components to be considered in the framework and approach stage and whether there are any other particular components that the AER considers is to be considered in the framework and approach stage by at least 30 months before the end of the current regulatory period;
4. the AER must then commence consultation on the framework and approach paper on that particular component or components; and
5. the AER must have completed and published the framework and approach paper by at least 23 months prior to the end of the current regulatory period.

Unlike the steps for the AER to consider whether to trigger the stage, if the NSP triggers the stage on a particular component or components, then the AER is not required to consult with stakeholders on whether to trigger the stage on that particular component or components. In such a scenario, the reason that the NSP will be required to notify the AER at least 32 months before the end of the current regulatory period is to give the AER enough notice so it avoids unnecessarily consulting with other stakeholders on whether to trigger the stage on that particular component or components, which would have occurred one month later but for the NSP triggering the stage. The NSP is to provide reasons to the AER for triggering the stage to assist the AER and other stakeholders when they consider whether other components should be triggered that the NSP had not triggered. Notwithstanding the above, the AER is still required to consult on other components that the NSP does not trigger.

As there must be a framework and approach paper in respect of dual function assets, it is necessary for the determination on the price regulation of dual function assets to be brought forward to be aligned with the framework and approach paper process. To give the AER enough notice, the AER is advised of the value of the relevant dual function assets before it commences consultation on whether to initiate a framework and approach paper. This means that the AER is advised on this value at least 32 months prior to the end of the current regulatory control period. Given that the value ascribed to the relevant dual function assets must correspond to an opening value for a regulatory year, the time as at which this value must be determined needs to be 36 months prior to the end of the current regulatory period.

Threshold for departing from a component in the framework and approach paper

The AER will be able to depart from the framework and approach paper in respect of the components covered by it during the regulatory determination process. For example, service classifications and the formulaic expression of the control mechanisms can depart from the framework and approach paper for unforeseen circumstances. Another example is the AER can depart from the relevant framework and approach paper for the application of incentive schemes during the regulatory determination stage, although it must give reasons for doing so. However, the form of the control mechanism and the pricing of services provided by dual function assets continue to be set as in the framework and approach paper.

An example of how the "unforeseen circumstance" threshold could be applied may be with respect to a pending judicial decision where a service classification is contingent on that decision. Here, the pending judicial decision is one event and the actual judicial decision is another event. Although it may be argued that the pending judicial decision is foreseeable, the actual judicial decision could probably not be reasonably foreseen until the decision has been made. The service classification would have to be based on what is known at the time the framework and approach paper is made, but could be departed from once the actual judicial decision is made. On the other hand, if the judicial decision was foreseeable at the time of the framework and approach stage, then the service classification should have been classified at that stage and it would not be appropriate to depart from this at a later stage as it was foreseeable. Nevertheless, the AER has the responsibility to consider whether a change in circumstances was foreseeable or unforeseeable.

11 Diverse issues

Summary

- The capex reopener and contingent project mechanisms has been introduced in Chapter 6 of the NER (distribution) to allow for efficient costs to be recovered for unexpected events. The contingent project threshold has been set to the greater of \$30 million or five per cent of the annual revenue requirement (ARR) or maximum allowed revenue (MAR) for transmission and distribution. A materiality threshold of one per cent of the ARR will apply to cost pass through applications in distribution. These changes will bring the uncertainty regime for distribution into line with transmission.
- The AER's decision-making timeframe for applications made under the uncertainty regime has been aligned between distribution and transmission. Some flexibility has been given in the timeframe to account for complex or difficult issues, and waiting on information from certain third parties. This will provide the appropriate balance between certainty and finality with flexibility in the process.
- The AER's power to revoke and substitute a decision for a material error or deficiency under Chapter 6A has been limited to "computational" errors by the AER or false or misleading information provided to the AER by another party. This will bring into line the AER's power with Chapter 6, as well as providing for finality and certainty in the process.
- The AER has been given the power to establish the shared assets cost adjustment mechanism. This will apply to assets which provide standard control services or prescribed transmission services as well as unregulated services. The shared assets cost adjustment mechanism will be designed in accordance with specific principles and guidelines. This will allow for innovation by NSPs and cost reflectivity for customers of standard control services or prescribed transmission services.
- Balancing the promotion of innovation and flexibility in regulation with good regulatory practice, the AER will be able to develop small scale pilot or test incentive schemes. This will allow the potential impact of such an incentive scheme to be understood before full implementation.

Difference between draft rule and final rule

- In the draft rule, the contingent project thresholds were to be linked to the greater of five per cent of the MAR or ARR and the RIT-T, as varied, for transmission and the proposed RIT-D, as varied, for distribution. In the final rule, the distribution and transmission contingent project thresholds are based on the greater of \$30 million or five per cent of the ARR or MAR, respectively.

- In the draft rule, the shared assets cost adjustment mechanism was to only apply to a shared asset providing both standard control services and alternative control services or unregulated services in distribution, and both prescribed transmission services and unregulated services in transmission. The final rule limits the mechanism to a shared asset providing both standard control services and unregulated services in distribution, and both prescribed transmission services and unregulated services in transmission.

11.1 Introduction

The AER raised in its rule change request certain diverse issues. These related to:

- the appropriateness of applying particular uncertainty regime mechanisms in distribution and aligning decision-making timeframes for the uncertainty regime mechanisms;
- when the AER can revoke and substitute regulatory determinations to address material errors;
- how shared assets should be regulated; and
- the development of small scale incentive schemes.

11.1.1 Uncertainty regime

Like most businesses, a NSP operates in an uncertain environment.³⁸¹ Uncontrollable external events can alter the quantity and nature of services required to be provided.³⁸² In a normal competitive environment, production and pricing behaviour would adjust to respond to these changes where efficient producers can recover their costs and should generally earn at least a normal return on their investments.³⁸³ The regulatory arrangements, including the uncertainty regime, attempt to mimic the competitive market by allowing the NSP to alter its production behaviour to meet market demand and undertake unexpected investment in new network capacity.³⁸⁴

For the purposes of this final rule determination, the "uncertainty regime" under the NER comprises contingent projects, capex reopeners and pass through events. These mechanisms deal with expenditure that is required to be undertaken during a regulatory period but which is not able to be predicted with reasonable certainty at the time of preparing or submitting a regulatory proposal to the AER for the start of the next regulatory period. A more accessible uncertainty regime will, on the one hand, facilitate certain capex or opex projects being undertaken, though on the other hand it

³⁸¹ AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 54.

³⁸² Ibid.

³⁸³ Ibid.

³⁸⁴ Ibid.

¹⁸² Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services