DRAFT NATIONAL ELECTRICITY AMENDMENT (ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS) RULE 2012—AER COMMENTS

No	Draft Rule	Suggested drafting	Comments
1.	6.4A(a) 6A.5A(a)	The *capital expenditure incentive objective* is to ensure that, where the value of a regulatory asset base is subject to adjustment in accordance with the *Rules*, then (except as otherwise provided in the *Rules*) the only capital expenditure that is included in an adjustment that increases the value of that regulatory asset base is capital expenditure that the *AER* is satisfied reasonably reflects the *capital expenditure criteria*.	The concept of 'reasonably reflects the capital expenditure criteria' should be at the AER's satisfaction; consistent with clause 6.5.7(c) and 6A.6.7(c).
2.	6.4A(b)(4a) 6A.5A(b)(4a)	the manner in which it proposes to assess the capital expenditure that is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent with the policy submitted to the *AER* under clause S6.1.1(8);	The capital expenditure incentive guidelines should also set out how the AER is to assess operating expenditure that has been capitalised, for consistency with clause S6.2.2A.
3.	6.5.2(b)	(b) The *allowed rate of return* for a *Distribution Network Service Provider* must correspond to the efficient financing costs, of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the *Distribution Network Service Provider* in respect of the provision of *standard control services* (the *allowed rate of return objective*). determined on a nominal post-tax basis that is consistent with the estimate of the value of imputation credits referred to in clause 6.5.3.	The AER supports the requirement that the allowed rate of return be calculated on a nominal post-tax basis (as currently set out in clause 6.5.2(c)(2)). The addition of this requirement in paragraph (b) ensures clarity and avoids the legal difficulties that have been identified in the AER submission concerning clauses 6.5.2(c), (e) and (f). The AER notes the ERA's submission, which commented on the specification of the post-tax nominal rate of return. As highlighted in the ERA's submission, the AER's post-tax nominal approach (as per the existing electricity rules) calculates the sum of the return *on* and *of* capital building blocks that equal the sum of these building blocks calculated under the ERA's real post-tax approach. The ERA's submission then went on to state that its modelling of the two approaches identified some revenue differences. However, it appears these revenue differences are driven by the adoption of specific modelling assumptions rather than whether a *nominal* rate of return or *real* rate of return framework is applied. For example, the AER considers that the likely cause of the identified revenue differences are the result of employing different tax input modelling and cash flow timing assumptions between the AER's modelling approach and the ERA's modelling approach. The AER considers there are advantages to maintaining the nominal rate of return framework. These include: ▪ The AER's previous application of the nominal rate of return

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			framework to all gas and electricity businesses ensures that the rate of return can be compared on a consistent basis. It also avoids the need to direct resources to maintaining different revenue models that deliver the same outcome in terms of the underlying rate of return framework—that is, the sum of the return *on* and *of* capital building blocks. ▪ The nominal rate of return is directly comparable with financial benchmarks for other investments. Financial markets are also familiar with such benchmarks as they typically express earnings and rates of return in nominal (post-tax) terms. Using a nominal post-tax rate of return therefore reduces confusion over the interpretation of the regulatory rate of return. ▪ The calculation of depreciation in a nominal framework is transparent and there is no confusion regarding the extent of revenue recovery. This is because in a nominal framework accumulated depreciation allowances equate to the change in the asset base valuation over time. The ACCC previously considered issues associated with adopting a nominal or real rate of return framework. Further details on the last two points can be found in the ACCC's 1999 *Draft statement of regulatory principles (supplementary papers):* http://www.aer.gov.au/sites/default/files/Draft%20statement%20of%20regulatory%20%20principles%20supplementary%20papers%20%2827%20May%201999%29.pdf (section 8) The ERA's submission stated that the proposed draft rule for the allowed rate of return objective should include the key words of "well accepted" from the existing gas rule 87(2)(b). The AER considers there is merit in this proposal. Based on its experience in assessing rate of return proposals, the AER agrees with the ERA that the ability to refer to guidance such as that in rule 87(2)(b) enables the regulatory decision making process to be more workable. In these circumstances, the regulator is able to make its decision with reference to the acceptability or otherwise of alternative rate of return approaches within academic, financial and regulatory professions.

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4.	6.5.2(c)	~~The *allowed rate of return* for a *regulatory year* must be determined:~~ ~~(1) as a weighted average of the return on equity for the *regulatory control period* in which that *regulatory year* occurs (as estimated under paragraph (e)) and the return on debt for that *regulatory year* (as estimated under paragraph (f)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed by an efficiently financed benchmark efficient entity with a similar nature and degree of risk as that which applies to the *Distribution Network Service Provider* in respect of the provision of *standard control services*; and~~ ~~(2) on a nominal post-tax basis that is consistent with the estimate of the value of imputation credits referred to in clause 6.5.3; and~~ ~~(3) taking into account relevant estimation methods, financial models, market data and other evidence.~~	The clause should be deleted as it unintentionally limits the ability of the AER to set an overall rate of return that reflects the AEMC's rate of return objective. This is because the drafting of the rules would require the AER to determine a point estimate for the return on equity and a point estimate for the return on debt, which would be based on separate (though partly overlapping requirements), and "mechanistically" brought together through a point estimate gearing ratio. This detracts from the AEMC's overall rate of return objective. As an alternative, these prescriptive requirements could be recast as matters that the AER is to have regard to when determining the allowed rate of return eg the AER is to have regard to the desirability of determining the allowed rate of return as a weighted average of the return on equity and the return on debt. Currently, clause 6.5.2(d) lists some factors that the AER must have regard to when making its decision. This could be expanded to include the criteria listed in clauses 6.5.2 (c), (e) and (h) -other than the criterion in (c)(2) which we have suggested moving to clause 6.5.2(b).
5.	6.5.2(e)	~~The return on equity for a *regulatory control period* must be estimated:~~ ~~(1) in a way that is consistent with the *allowed rate of return objective*; and~~ ~~(2) taking into account the prevailing conditions in the market for equity.~~	See the comments for clause 6.5.2(c). This clause should also be deleted. Prescribing a rule for the determination of the return on equity detracts from the purpose of the AEMC's overall rate of return objective. It could potentially be incorporated into matters that the AER takes into account when making a determination or issuing guidelines.
6.	6.5.2(f) 6A.6.2(f)	Delete the clause. If the clause is not deleted, it should be amended as follows: The return on debt for a *regulatory year* must be estimated: (1) in a way that is consistent with the *allowed rate of return objective*; and (2) using a methodology under which: (i) the return on debt for each *regulatory year* in the *regulatory*	See the comments for clauses 6.5.2(c) and (e). This clause should also be deleted. It prescribes a method for determining a component of the rate of return and in doing so detracts from the purpose of the AEMC's overall rate of return objective. If the clause is not deleted, it would appear to require amendment. The proposed new clauses 6.5.2(f), 6.5.2(i) and 6.12.1(5a) (and equivalents in transmission) do not appear to work together. Proposed new clause 6.5.2(f) mandates that the methodology used to estimate return on debt must comply with one of two options listed in clause 6.5.2(f)(2). However, the way proposed new

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		control period is the same; or; (ii) the return on debt for ~~a~~ *regulatory years* ~~(other than the first *regulatory year* in the *regulatory control period* may be different) is estimated using a methodology which complies with paragraph (i)~~.	clauses 6.5.2(i) and 6.12.1(5a) are worded assumes that it is possible to use a methodology different from one of those two options allowed under clause 6.5.2(f). There is no provision in the new rules that would permit this. The particular issue with clause 6.5.2(i) is discussed below. We think we understand the intention behind the changes. Namely, it was intended that a methodology that allowed for either a consistent return on debt over the whole regulatory period, or annual changes in the return on debt, would be acceptable. If a methodology was chosen that provided for an annual change to the return on debt then the formula for determining that change had to be fixed in the distribution determination, as the change to the return on debt would have an impact on annual revenue requirements. However, the proposed changes do not give effect to that intention. We have therefore suggested amendments to clauses 6.5.2(f)(2)(ii), 6.5.2(i) and 6.12.1(5a) which we think give effect to the AEMC's intention. See also the following two items for clauses 6.5.2(i) and 6.12.1(5a). This will not be an issue if the clause is deleted.
7.	6.5.2(g) 6A.6.2(g)	~~Subject to paragraph (f), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting:~~ ~~(1) the return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the making of the distribution determination for the *regulatory control period*;~~ ~~(2) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over an historical period prior to the time when the distribution determination for that *regulatory control period* is made; or~~ ~~(3) some combination of the returns referred to in subparagraphs (1) and (2).~~	Clause 6.5.2(g) should be deleted for the same reason that clause 6.5.2(f) should be deleted—the paragraphs detract from the AEMC's intention for achieving an overall rate of return objective. Further, the clause does not appear to allow an annual update based on trailing debt yields *during* the regulatory control period. Specifically, 6.5.2(g)(1) and (2) allow return on debt estimates based on debt raised *prior* to the time when the determination for that regulatory control period is made. This seemingly excludes a trailing average approach whereby, for example, the return on debt in year 4 of the regulatory control period reflects, in part, data from years 1, 2 and 3 of the same period. The provision appears to be unnecessary in any case given the flexibility built into other clauses and the presumption that arises from the different wording used in the provisions that prescribe how the AER is to estimate return on debt and return on equity.

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8.	6.5.2(h) 6A.6.2(h)	In determining whether the allowed rate of return ~~on debt for a *regulatory year*~~ is estimated in a way that is consistent with the *allowed rate of return objective*, regard must be had to the following factors: (1) the standard practices of industry participants for raising debt and equity~~the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity referred to in subparagraph (c)(1) and the return on debt over the *regulatory control period*~~; (2) the impact on electricity consumers~~, including due to any impact on the return on equity of a benchmark efficient entity referred to in subparagraph (c)(1)~~; (3) the incentive effects of inefficiently delaying or bringing forward capital expenditure; and (4) the impact of changing the methodology for estimating the return on debt across regulatory control periods.	To ensure that the AEMC's overall rate of return objective is given full effect, this clause should apply generally to the allowed rate of return rather than just to the return on debt. In addition, the meaning of paragraphs (1) and (2) is not clear. Paragraph (1) highlights that the AER should have regard to any significant differences between the cost of debt of a benchmark efficient entity and the return on debt calculated under the rules. However, the two would presumably be the same (that is, the return on debt is meant to be the return on debt of a benchmark efficient entity). We understand the intention was that the AER should have regard to the standard practices of businesses within the industry when raising debt (when considering whether the return on debt in the determination complies with the objective). We have therefore suggested some changes to the wording to reflect these concerns.
9.	6.5.2(i) 6A.6.2(i)	The clause should be deleted. If the clause is not deleted, it should be replaced with: If the methodology to determine the allowed rate of return will result in different rates of return applying in different *regulatory years* during a *regulatory control period*, a resulting change to an *annual revenue requirement* must be effected through the automatic application of a formula that is specified in the distribution determination.	The clause should be deleted, for the same reason that other clauses prescribing how the rate of return must be calculated should also be deleted. Prescribing how the rate of return must be determined detracts from the AEMC's intention of an overall rate of return objective. However, the AER agrees with the policy intention behind the clause, namely, if in determining an allowed rate of return, it is decided that there should be an annual update mechanism, then that annual update should be based on the automatic application of a formula set out in the determination. If the clause is not deleted, as noted in the above item for clause 6.5.2(f) (and 6A.6.2(f)), the provision assumes that it is possible to estimate the return on debt in a manner that does not comply with clause 6.5.2(f). That is not possible.
10.	6.12.1(5a) 6A.14.1(5C)	This clause should be deleted. If it is not deleted, it should be amended as follows:	The clause should be deleted for the same reason that clause 6.5.2(c), (e) and (f) should be deleted (see notes for those items above. If the clause is not deleted the AEMC's proposal for an

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		(5a) a decision on ~~whether~~ the methodology to be used to calculate the return on debt, and if it ~~for a *regulatory year* of the *regulatory control period*~~ is ~~not to be determined using~~ a methodology referred to in clause 6.5.2(f)(2)(ii) ~~and, if that is the case~~, the formula that is to be applied in accordance with clause 6.5.2(~~h~~i)	overall rate of return objective will not be met. However, if those clauses are not deleted, the clause should be amended. Without amendments, the provision assumes that it is possible to estimate the return on debt in a manner that does not comply with proposed clause 6.5.2(f). That is not possible. It also incorrectly cross-references clause 6.5.2(h) instead of clause 6.5.2(i).
11.	6.5.6(e)(5A) 6.5.7(e)(5A) 6A.6.6(e)(5A) 6A.6.7(e)(5A)	the extent to which the operating expenditure forecast ~~includes expenditure to~~ addresses the concerns of any electricity consumers to the extent those concerns have been identified by the *Distribution Network Service Provider* in the course of its engagement with electricity consumers;	The expression "includes expenditure to" is confusing: the total of the operating expenditure forecast should be in part determined to address the concerns of consumers, given it must achieve the operating expenditure objectives, be consistent with the revenue and pricing principles and must be determined in a manner that, together with the rest of the distribution determination, contributes to the achievement of the national electricity objective.
12.	6.5.6(e)(11) 6.5.7(e)(11) 6A.6.6(e)(14) 6A.6.7(e)(14)	any other factor the *AER* considers relevant and which the *AER* has notified the *Distribution Network Service Provider* in writing, prior to the submission of its revised *regulatory proposal* under clause 6.10.3~~6.8.2~~ or any further submissions under clause 6.10.4, if any, is an operating expenditure factor.	Other relevant factors may arise during the regulatory process after the submission of a regulatory proposal. There appears to be no justification to exclude any such relevant factors, so long as NSP is informed of them. Informing the NSP may occur up until the further submissions stage set out at clause 6.10.4.
13.	6.5.8A(c)(2) 6A.6.5A(c)(2)	the rewards ~~and~~or penalties should be commensurate with the efficiencies or inefficiencies in capital expenditure, but ~~a reward for efficient capital expenditure~~ need not correspond to the ~~in~~ amount ~~to a penalty for the same amount~~ of efficient or inefficient capital expenditure incurred; and	We have suggested drafting changes to clarify that the reward or penalty should appropriately correspond to the issue being rewarded or penalised but need not correspond to the amount of efficient or inefficient expenditure.
14.	6.5.8A(c)(3) 6A.6.5(c)(3)	~~penalties should not be imposed on *Distribution Network Service Providers* that undertake capital expenditure in an efficient manner, in terms of both its amount and timing.~~	It is unclear what work this provision is intended to do. The first part of the provision is uncontroversial and seems an obvious inference from subparagraph (1). The expression "amount and timing" is imprecise and broad.
15.	6.5.8(d)(2)	~~any applicable *regulatory obligations or requirements* associated with the provision of *standard control services*~~the *capital expenditure objectives* and, if relevant, the *operating expenditure objectives*.	Compliance with all regulatory obligations or requirements is one of four capital expenditure objectives listed at clause 6.5.7(a). It is unclear why this objective is more important than the others. A capital expenditure scheme should take into account all of these objectives. The operating expenditure factors at clause 6.5.6(a)

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			may also be relevant, given clause 6.5.8A(d)(1) recognises that there may be interactions between efficient operating expenditure and capital expenditure.
16.	6.5.8A	(f) The *AER* may, from time to time and in accordance with the *distribution consultation procedures*, amend or replace a *capital expenditure sharing scheme*.	We note that this clause should be consistent with clause 6.5.8(d).
17.	6.5.8A(e)(4)(ii) 6A.6.5A(f)(4)(iii)	~~the~~any circumstances of the *Distribution Network Service Provider* which, in the opinion of the *AER*, are relevant to that decision.	We agree that it is desirable for the AER to have flexibility to take into account a variety of factors which are not necessarily spelt out in the Rules. However, the current language is capable of being interpreted extremely broadly and could give rise to problems similar to those that the AER currently experiences in relation to clause 6.5.6(c)(2) (among others). A preferable approach would be to make it clear that it is a matter for the AER's judgement to determine which circumstances are relevant to its decision on the capex incentive mechanism for a particular service provider.
18.	6.6.4(b)(5) 6A.7.5(b)(5)	the interaction of the scheme ~~should be consistent~~ with other incentives that *Distribution Network Service Providers* may have under the *Rules*; and	Incentives in the Rules may not necessarily be consistent with each other. What is important is that the AER must have regard to any interactions between consistent or competing incentives, so as to ensure that the distribution or transmission determination is consistent with the revenue and pricing principles and is made in a manner that will contribute to the achievement of the national electricity objective. We note that the equivalent new clause 6.5.8A(d)(1) refers to 'interaction' rather than consistency.
19.	6.6.5(f)(1)	to adjust the forecast capital expenditure for that *regulatory control period* to accommodate the amount of such additional capital expenditure as the *AER* ~~determines is appropriate~~is satisfied reasonably reflects the *capital expenditure criteria* (in which case the amount of the adjustment will be taken to be accepted by the *AER* under clause 6.5.7(c)); and	This clause should be amended for consistency with clause 6.5.7(c) and clause 6.6A.1(b)(2)(ii).
20.	6.8.2(c)(6)	an identification of any parts of the *regulatory proposal* the	If clause 6.14A remains, 6.8.2(c)(6) should be consistent with

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	6A.10.1(f)(2)	*Distribution Network Service Provider* claims to be confidential and wants suppressed from publication on that ground ~~including, for each such part, a classification of the information in that part~~ in accordance with the *Distribution Confidentiality Guidelines*.	drafting of 6.14A(b) – that is the guidelines *may* include categories of confidential information by reference to which DNSPs must classify any claims (but may not). In addition, it would be preferable to highlight that the claim for confidentiality should be in accordance with the guidelines as a whole (and not simply in relation to classifications).
21.	6.12.3(f) 6A.13.2(a) and (b)	Delete clauses 6.12.3(f) and 6A.13.2(a) and (b). Alternatively: 1. Amend clause 6.12.3(f) as follows: If the *AER* refuses to approve an amount or value referred to in clause 6.12.1 (other than those amounts or values referred to in clauses 6.12.1(3)(ii), 6.12.1(4)(ii) or 6.12.1(5)), the substitute amount or value on which the distribution determination is based must be: (1) determined ~~on the basis~~having regard to ~~of~~ the current *regulatory proposal*; and (2) any preferable alternative in the opinion of the *AER* that complies ~~amended from that basis only to the extent necessary to enable it to be approved in accordance~~ with the *Rules*. 2. Amend clause 6A.13.2(a) as follows: If the *AER's* final decision is to refuse to approve an amount or value referred to in clause 6A.14.1(1), the *AER* must include in its final decision a substitute amount or value which, except as provided in paragraph (b), is: (1) determined ~~on the basis of~~ having regard to the current *Revenue Proposal*; and (2) any preferable alternative in the opinion of the *AER* that complies ~~amended from that basis only to the extent necessary to enable it to be approved in accordance~~ with the *Rules*. This paragraph (a) does not apply in respect of the determination of	The clauses should be deleted. While the overall capex, opex and rate or return decisions are no longer subject to the restriction in this clause, the component decisions that must be made in making an overall decision on capex, opex and rate of return will continue to be subject to the restriction in this clause. That will defeat the purpose of removing overall capex, opex and rate of return decisions from the clause. If the purpose of the provision is to ensure that the AER has appropriate regard to the service provider's proposal when making its decision, a preferable alternative may be to have a more general positive obligation on the AER to consider the proposal against other alternatives, as currently applies under the *National Gas Rules* (see left column). Alternatively, the provision could be recast as a positive obligation that only applies to those specific aspects of the proposal where the regulator should not have a broad and holistic discretion. The current clause operates as a 'catch all'. It applies a general restriction on the AER's powers.

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		an *allowed rate of return* under clause 6A.6.2.	
22.	S6.2.2 S6A.2.2	In determining the prudency or efficiency of capital expenditure the *AER* must only take into account information and analysis that ~~the provider could reasonably be expected to have considered or undertaken at the time that it~~ would have been reasonably available at the time *Distribution Network Service Provider* undertook the relevant capital expenditure.	This clause could limit the AER's ability to conduct ex post reviews using top-down information that incorporates information from other regulated businesses that is not available to the NSP. The amendments restrict the information that can be used by the AER to that information that it would have had access to at the time the service provider undertook the expenditure.