



**Response to AEMC consultation paper**

**Economic Regulation of Network Service  
Providers**

December 2011

# 1 Summary

The AER welcomes the opportunity to provide a submission on the Australian Energy Market Commission (AEMC) consultation paper on the Economic Regulation of Network Service Providers rule amendment proposals. At this stage of the review process, the AER is focussing on the question raised by the AEMC regarding whether the problems identified in the rule change proposal are issues with the current rules, specifically in relation to the setting of forecasts of required expenditure.

The AER makes this submission to clarify the distinction between the chapter 6 rules that apply to distribution networks and those in chapter 6A applying to transmission networks. As outlined in the rule change proposal, both chapters currently establish a two stage process for the assessment of forecasts of required expenditure. Both chapters require the AER to accept proposals from network businesses if it is satisfied they 'reasonably reflect' efficient, prudent and realistic expenditure. Accordingly, the first step is for the AER to determine whether it is satisfied that the total forecast reasonably reflects the expenditure criteria, taking into account the expenditure factors. In the event that the AER is not satisfied, then both chapters require that the total be rejected and that a substitute forecast be formed.

In chapter 6, the AER is explicitly restricted to only amending amounts and values that are constituent decisions on the basis of the regulatory proposal and to the minimum extent necessary to enable it to be approved under the rules, including forecasts of capital and operating expenditure. The same restrictions apply for substituting the proposed maximum allowed revenue and total revenue cap in chapter 6A, however, separate processes apply for substituting forecast expenditure in draft and final decisions.

In making a transmission draft decision, the AER is required to detail the changes to the revenue proposal that would be required before the AER will approve those amounts or values. Therefore the AER must address the revenue proposal on its own terms to identify changes that are required to enable it to be approved. While seemingly more freedom is allowed in the substitution in a transmission final decision, the AER must again consider the revenue proposal in determining a substitute forecast. This issue is compounded when considered alongside procedural fairness considerations that must be afforded to stakeholders throughout the process of moving from a draft to final decision.

The existing Revenue and Pricing Principles (principles) in the National Electricity Law (NEL) require that network businesses be afforded a reasonable opportunity to recover at least the efficient costs of providing the required services. The AER considers that changes to the rules are required to enable processes that deliver on both the National Electricity Objective (NEO) and the principles. The current rules were designed to provide additional limits on regulatory discretion, rather than relying on the protections already set out in the NEL. Going further than the NEL protections in this fashion has led to unintended consequences, with consumers ultimately paying more than is required for a safe and reliable electricity supply.

The AER considers that the issues identified in our rule change proposal are clearly problems with the current rules and that changes are required to ensure that impartial forecasts of required expenditure can be set, bounded by the requirements of the NEL.

## 2 The National Electricity Law

Section 7A of the NEL contains seven principles that must be taken into account by both the regulator in making revenue determinations and the AEMC in its rule making capacity. Three of these principles are central to the AER's rule change proposal.

First, regulated network service providers should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing services and complying with regulatory obligations. Explicit in this principle is that neither the AEMC nor the AER can act to deny the recovery of the efficient costs associated with the provision of the required services. This is a critical consideration and one that has been at the heart of the development of the AER proposal.

Second, regulated network service providers should be provided with effective incentives in order to promote economic efficiency including efficient investment in and provision and use of network services. In line with this principle, the AER's proposal includes mechanisms that promote effective incentives for efficient investment.

Third, there is a need to have regard to the economic costs and risks of the potential for under and over investment by a regulated network service provider. It is recognised that the economic cost of under-investment in services is greater than the economic cost of a small over-investment. This asymmetry is well understood in regulatory economics and is central to the deliberations of regulators. Again, this asymmetry is something that the AER has explicitly acknowledged and addressed as part of our rule change proposal.

The internal AER review that led to the development of this rule change proposal found that the principles in the NEL are providing a clear and transparent protection for businesses. Under the AER's proposal, revenue determinations would be subject to the clear and consistent set of principles in the NEL and the existing expenditure objectives in the rules. This means that decisions of the AER will still require networks to be afforded a reasonable opportunity to recover at least efficient cost, but removes the ambiguous inclusion of both 'what to do' and 'how to do it' procedural and substantive factors that currently reside in the rules.

The AER considers that these protections in the NEL need to be borne in mind when considering our rule change proposal. Network businesses are adequately protected without the need for further restrictions in the rules.

Within regulation, it must be assumed that policy makers intended that all the rules were included for a purpose and the regulator must give effect to all the provisions. Statutory interpretation principles provide guidance on how to resolve conflicts between different provisions. Attempting to ensure that networks recover at least the efficient cost of providing the required services by codifying the procedures and methodologies of regulation or restating the objectives or principles may not present a direct conflict. However, this 'belts and braces' approach has consequences (perhaps unintended) which ultimately result in consumers paying more than is required for a safe and reliable electricity supply.

### 3 Legal debate around ‘reasonably reflects’

During the latter stages of the AEMC’s consultation on the economic regulation of transmission services in 2006, there was a substantial debate concerning the treatment of expenditure forecasts. The debate focussed on whether the AER’s decision on whether forecast costs were efficient should be subject to a ‘reasonable estimate’ test or a ‘best estimate’ test.

Consumer groups, the AER and a number of Federal and State government departments argued that the reasonable estimate test would result in upwardly biased estimates. In particular, the Department of Industry, Tourism and Resources (DITR) submitted legal advice received from the Australian Government Solicitor which concluded that “the use of the ‘reasonable estimate’ test... will result in the AER being required to accept a range of forecasts higher than those it would determine as the most appropriate or best estimate.”<sup>1</sup>

Network representatives, on the other hand, argued that networks would not seek to exploit a ‘reasonable estimate’ test since to do so would be in breach of the Rules requirement to submit a forecast which the Transmission Network Service Provider (TNSP) genuinely considers to be reasonably required. In addition, a forecast at the top end of the reasonable range would carry the risk of overreaching and of thereby allowing the AER to make and substitute its own estimate.<sup>2</sup>

Following consideration of the views expressed during the consultation process, the AEMC concluded that it was necessary to clarify the intent of its framework for determining capital and operating expenditure forecasts.<sup>3</sup> It sought to achieve this by:

- better specifying the expenditure objectives
- better specifying the procedural requirements
- re-phrasing the decision-making rule, such that the AER must accept the TNSP’s forecast if it is satisfied that the forecast reasonably reflects efficient costs.<sup>4</sup>

This formulation, coming as it did at the culmination of a protracted consultation process, was not itself subject to consultation. Even at the time it was drafted, it was unclear how the provisions would operate in practice.

For instance, in light of submissions to the draft determination, the AEMC adopted the language that the AER must ‘be satisfied’ rather than the AER must ‘determine’ in the belief that this would help to restrict the grounds for judicial review. However, even the AEMC’s own legal advisor, Neil Williams SC, commented that “the restriction upon judicial review that

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<sup>1</sup> Legal advice from the Australian Government Solicitor, 10 October 2006, pg. 3.

<sup>2</sup> Legal advice provided to ETNOF by Stephen Gageler SC, 25 October 2006, para 16.

<sup>3</sup> AEMC, Rule Determination Economic Regulation of Transmission Services, November 2006, pg 48.

<sup>4</sup> Op. cit, pg 51.

such a drafting device imposes should not be overstated, and is, in some respects, more apparent than real”.<sup>5</sup>

The AEMC’s final decision represented a refinement of the ‘reasonable estimate’ test used in the draft decision, but the practical implications of the final decision is that the changes were not sufficient to avert the bias in favour of the network service providers associated with the ‘reasonable estimates’ test.

## 4 The process for setting required expenditure

In both chapters 6 and 6A there is a two stage process for the setting of forecasts of required operating and capital expenditure. The first stage begins with the network business submitting a revenue proposal that must include the total forecast of capital and operating expenditure which the network business considers is required in order to achieve the capital and operating expenditure objectives respectively. The expenditure objectives in turn refer to the requirement to meet expected demand, comply with applicable regulatory obligations, and to maintain quality and reliability of supply. The AER then considers the revenue proposal from the business and determines whether or not it is satisfied that the proposed total forecast ‘reasonably reflects’ the required costs of a prudent operator. The process for forming this decision is common across chapters 6 and 6A and is outlined in section 4.1.

The second stage of the process occurs when the AER is not satisfied that the proposed total reasonably reflects the required expenditure and a substitute forecast must be determined. In this case, different requirements are on the AER depending on whether the AER is issuing:

- a transmission draft decision – as discussed in 4.2
- a transmission final decision – as discussed in 4.3
- either a draft or final distribution decision – as discussed in 4.4.

In all cases the AER is required to consider the information provided by the network business. At no stage is it permitted to set aside either the initial or revised proposal in determining a substitute forecast—as has been claimed by some stakeholders.

### 4.1 Must accept if satisfied ‘reasonably reflects’ test

The framework for the first step in setting the forecast of required operating and capital expenditure is the same across distribution and transmission. In both cases, the requirement is that the AER must accept the forecast of required expenditure that is included in the revenue proposal if the AER is satisfied that the total of the forecast expenditure reasonably reflects:

- the efficient costs of achieving the expenditure objectives

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<sup>5</sup> Neil Williams SC, *Memorandum of Advice in the matter of Draft National Electricity Amendment (Economic Regulation of Prescribed transmission Services) Rule 2006*, 24 October 2006, paragraph 35.

- the costs that a prudent operator in the circumstances of the network business would require to achieve the expenditure objectives
- a realistic expectation of the demand forecasts and the cost of inputs required to achieve the expenditure objectives.

This requirement is set out in clauses 6.5.6(c), 6.5.7(c), 6A6.6(c) and 6A.6.7(c), with only minor variation to cater for either 'capital' or 'operating' expenditure. In deciding whether or not the AER is satisfied pursuant to these clauses, the AER must have regard to the expenditure factors. Again these expenditure factors are set out with minor differences for either capital or operating expenditure. Common among all, however, is that the first factor that must be considered is the information included in or accompanying the revenue proposal.

The expenditure factors are referred to in several places throughout the forecast setting provisions, including in guiding the AER in substituting a forecast amount where it is not satisfied with a proposal. The continued reference to the expenditure factors that in turn require considering information in or accompany the revenue proposal highlights two distinct problems. First, it highlights the significance placed on the revenue proposal throughout the assessment process, including in circumstances where the AER must determine a substitute forecast.

Second, as set out in rule change proposal, matters of process, such as the consideration of the information contained in the revenue proposal, have been conflated with factors that are used to assess the expenditure, for example—the relative prices of operating and capital inputs. The AER has proposed that this be remedied with the process matters being relocated to Part E of the rules.

Further, common across both chapter 6 and 6A is the imprecise language in the rules that requires the consideration of the costs of a prudent operator in the circumstances of the relevant network service provider. The imprecise nature of the language has the potential to cause disputes on the AER's ability to test the efficiency of the proposal is limited since ultimately the decision must be tied back to the circumstances of the relevant TNSP. As noted by Neil Williams SC:

This phrase qualifies the notion of efficiency or prudence to the circumstances of a particular applicant, and implies that efficiency is not to be applied objectively but contextually, in light of actual opportunities and constraints confronting the TNSP.<sup>6</sup>

As outlined in the rule change proposal, good benchmarking practice requires that the characteristics of the individual network be taken into account in the normalisation of the data, including matters such as network topography. However, this is different to taking into account the circumstances of the individual owner of the network. The imprecise language used in the current rules may limit the AER's ability to apply comparative analysis and benchmarking in identifying efficient costs.

After following this process the AER must determine whether it is satisfied with the proposed forecast. In the event that it is not satisfied, different rules apply for setting of a substitute forecast, depending on whether it is a distribution decision or a transmission draft or final

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<sup>6</sup> Neil Williams SC, *Memorandum of Advice in the matter of Draft National Electricity Amendment (Economic Regulation of Prescribed transmission Services) Rule 2006*, 24 October 2006, para 64.

decision. The process for each is described in the following sections. In all cases the significance of the revenue proposal established through the process outlined in the above section is maintained.

## 4.2 Electricity transmission draft decision

In electricity transmission the AER must issue a draft decision in accordance with clause 6A.12, including the reasons set out in clause 6A.14. The AER must set out whether it has approved or refused to approve the proposed forecast of required expenditure. For example, under clause 6A.14.2, the AER must set out the basis and rationale for any decision including:

- details of the qualitative and quantitative methods supplied in any calculations and formulae made or used by the AER for the purposes of this decision
- the values adopted by the AER for each of the input variables in any calculations including:
  - whether those values have been taken or derived from the network business' proposal, and
  - if not the rationale for the adoption of those values
- details of any assumptions made by the AER in undertaking any material qualitative and quantitative analysis for the purposes of the decision
- reasons for the making of any decisions, the giving or withholding of any approvals, and the exercise of any discretions for the purposes of the decision.

Where the AER has not accepted a proposed forecast of required expenditure the AER must set out its reasons for that decision and must provide an estimate of the required expenditure that the AER is satisfied reasonably reflects the expenditure criteria taking into consideration the expenditure factors. As outlined above, the first expenditure factor is the information in or accompanying the revenue proposal. That is, the AER must consider the revenue proposal in determining a substitute forecast.

Further, under clause 6A.12.1(c), if the AER refuses to approve any of the amounts or values referred to in clause 6A.14.1(1), the AER's draft decision must 'include details of the changes required or matters to be addressed before the AER will approve those amounts or values.' Clause 6A.14.1(1) refers to the contents of the AER's decisions in which the AER either approves or refuses to approve, amongst other things, the total revenue cap and the maximum allowed revenue for the network business.

A key component of both the total revenue cap and the maximum allowed revenue is forecasts of both capital and operating expenditure. The requirement that the AER include the details of the changes required or matters to be addressed before the AER will approve those amounts necessarily includes the AER setting out what changes would be required to both the capital and operating forecasts in order for them to be approved. In turn, this requires the AER to address the revenue proposal on its own terms to highlight the areas where changes are required to enable it to be approved.

As a result, the substitute amount determined by the AER in the draft decision will be the forecast proposed by the network business adjusted for any specific forecast costs identified that require amendment before they could be approved in the final decision. Accordingly, when issuing a draft decision, the chapter 6A provisions have the same practical effect as the chapter 6 provisions that require that the AER's response be based on the regulatory proposal, as described in section 4.4 below.

Following the issuing of a draft decision, the network business has the right to submit a revised proposal addressing the issues raised in the draft decision. If the forecast of required expenditure proposed by the network business is the same as that included in the draft decision, then the AER is bound to accept this forecast, subject to certain exceptions. In the event that the revised proposal includes a higher forecast than was included in the draft decision, then another two stage decision making process must be conducted, as set out in section 4.3.

However, it is also important to understand that the NEL and rules are not the only requirements on the AER as an administrative body. As highlighted above, in the draft decision the AER must set out its reasoning and methods for all constituent decisions. The process then allows for a revised proposal from the network business. Were the AER to fundamentally change its approach between draft and final decisions, no other stakeholders—including network businesses—would have the opportunity to comment on the changed methodology. Given the time constraints of the process required for the AER to make decisions, it is often not possible to afford procedural fairness to those stakeholders. As a result, often the only practical option for the AER is to stay within the bounds of the draft decision and the revised proposal.

These important procedural fairness considerations compound the problem of the AER being so heavily bound to the network business' proposal at the draft decision stage. As such, while there would appear to be a greater degree of freedom in the process for determining substitute forecasts at the final decision stage under chapter 6A, as discussed in the next section, this needs to be assessed alongside the broader requirements on the AER as an administrative body with responsibility for affording stakeholders an appropriate degree of procedural fairness.

### **4.3 Transmission final decision requirements**

Under 6A.13.2 if the AER's final decision is to refuse to approve, amongst other things, the total revenue cap, or the maximum allowed revenue, the AER must include in its final decision a substitute amount or value which is determined on the basis of the current revenue proposal and amended from that basis only to the extent necessary to enable it to be approved in accordance with the Rules.

However, unlike in chapter 6, forecast expenditure is an exception to this restriction and a separate process is established for the substitution of forecast expenditure. If the AER is not satisfied that the proposed total forecast reasonably reflects the expenditure criteria, taking into account the expenditure factors, it must (an identical provision applies for capital expenditure):

"include in its final decision (in addition to the estimate referred to in clause 6A.14.1(3)(ii)) the forecast operating expenditure for each regulatory year which the AER is satisfied reasonably reflects the operating expenditure criteria, taking into account the operating expenditure factors,

subject only to the requirement that the total of such forecasts must equate to the estimate referred to in clause 6A.14.1(3)(ii);”

In turn, 6A.14.1(3)(ii) requires that:

“the AER must set out its reasons for that decision and an estimate of the total of the Transmission Network Service Provider’s required operating expenditure for the regulatory control period that the AER is satisfied reasonably reflects the operating expenditure criteria, taking into account the operating expenditure factors.”

As highlighted in earlier sections, the requirement that the AER must have regard to the expenditure factors in determining a substitute forecast requires that the AER have regard to the information in or accompanying the revenue proposal. As such, quite aside from any procedural fairness concerns that were discussed in the previous section, the AER is still bound to consider the revenue proposal, even in determining a substitute forecast if it was not satisfied that the proposal reasonably reflected the required expenditure.

As a result of this continued focus on the revenue proposal and to ensure procedural fairness to the stakeholders, the AER experience is that the process of determining a substitute in the final decision does not allow it to completely set aside the revised proposal in determining a substitute. This has been a claim made by some stakeholders. Rather, the AER has found that the intended two stage process, where the AER first determines that it is not satisfied and then determines a substitute, becomes conflated to a one stage process.

In this practically conflated process, the reasons and justifications for finding that the AER is not satisfied that a proposal reasonably reflects required expenditure also becomes the justification for the substitute figure. Accordingly, again the substitute figure becomes the forecast proposed by the business minus any specific issues that have been identified by the AER in its analysis of the revenue proposal.

For example, in making the final decision, the AER needs to address all of the new information and justifications included in the revised proposal. If the concerns are maintained that were held in the draft decision, then a substitute forecast must be determined. However, to the extent the AER’s potential substitute forecasts are not based on the original proposal or the analysis and approach reflected in the draft decision, the network business (and other stakeholders) would have had no notice of AER’s substitute forecasts. As the businesses are entitled to procedural fairness, often the only practical option for the AER is to keep its final determination within the bounds of the draft decision and revised proposal. The time between the closing of submissions and the final AER decision is insufficient to allow for further consultation except in regards to limited issues. Again, this is an important consideration and highlights the need for the rules to be considered within the context of the AER’s broader decision making requirements, including administrative law and review processes (judicial and merits).

The AER rule change proposal would ensure that the draft decision can effectively set out the AER’s assessment of the revenue proposal, its own analysis and expert advice sought in determining a forecast that meets the requirements of the NEO and the principles. This contrasts with and addresses the current bias in favour of the proposal from the business that arises in the current rules. In particular, even if the AER is not satisfied the proposed total forecast reasonably reflects the required expenditure, in developing a substitute the AER must always begin with the business’ proposal and set out the changes to that proposal in the draft decision. In practice, this unduly ties the regulator to the network businesses’ proposal in the determination of the total forecast that ‘reasonably reflects’ the required expenditure.

While a proper consideration of the proposal from the business should always form part of the regulator's consideration of the required expenditure, the current rules limit the ability for the regulator to balance this with its own analysis before coming to a view on an impartial forecast of required expenditure.

Under the AER's proposal the draft decision would then form the basis for a revised proposal from the network business. The final decision would then balance the preliminary views as expressed in the draft decision against the further information contained in the revised proposal and stakeholder submissions. To the extent that there are departures from the draft decision, these would be based on the revised proposal or stakeholder submissions or any other further consultation that is possible within the time, thereby preserving procedural fairness. As highlighted in the rule change proposal, the AER considers that this is a better framework through which to achieve both the NEO and the principles.

#### **4.4 Further restrictions in distribution**

As is the case for transmission decisions, a distribution business submits its forecast of required expenditure and the AER must accept this if satisfied that the total reasonably reflects the required expenditure. The process of assessing this proposed forecast is similarly against the expenditure objectives, criteria and factors.

Again, if the AER is not satisfied that the total reasonably reflects required expenditure, it must determine a substitute forecast. Under clause 6.12.3(f), 'if the AER refuses to approve an amount or value referred to in clause 6.12.1, the substitute amount or value on which the distribution determination is based must be:

1. determined on the basis of the current regulatory proposal; and
2. amended from that basis only to the extent necessary to enable it to be approved in accordance with the Rules.'

Accordingly, if the AER considers that the proposed total forecast does not 'reasonably reflect' required expenditure, it may only reduce it to the minimum extent necessary to enable it to be approved under the rules. Regardless of any other forecast that both reasonably reflects the required expenditure and meets the requirements of the NEL, the rules lock in a bias towards forecasts proposed by the business.

Further, the requirement that the substitute be determined on the basis of the current regulatory proposal leads the regulator into assessing the cost build-up model that has been proposed by the business. So while we have found that we can test proposals using a range of different techniques and expert advice, we are limited in being able to use this information in determining the actual substitute forecast. Instead, a line by line assessment of the proposal is conducted in order to identify explicit cost reductions in order to bring the total back to the absolute top end of the 'reasonably reflects' range.

As noted above, while chapters 6 and 6A are struck differently, with chapter 6 being more explicit in the restrictions that it imposes, there is no significant difference in the practical application of the two sets of rules. In both cases, changes are required to ensure that an unbiased estimate of required expenditure can be set that meets both the revenue and pricing principles and the NEO.

## 5 The AER's proposed approach

In preference to the current approach, the AER has proposed that the rules should instead require that the AER determine the forecast of required expenditure. Such a determination would be bounded by the principles as set out in section 2 of this submission. The changes being proposed by the AER would allow a more balanced approach to setting forecasts, while ensuring that networks are funded to provide a safe and reliable electricity supply.

In many respects our proposal does not fundamentally alter the conduct of a regulatory reset process, which would still begin with a revenue proposal from the business, which in turn would still be the subject of extensive consideration and testing. The existing expenditure objectives remain unchanged from the current regime. The same applies to the transparent expenditure factors, where we only propose to relocate the process matters and clarify some of the remaining assessment factors.

As set out in this submission, the AER considers that the rules limit the regulator's ability to determine an independent forecast of required expenditure. However, to the extent that some stakeholders consider that the AER already has the discretion to establish an independent forecast, the AER's proposal removes potential for legalistic debate on this issue.

Under our proposal, the AER would assess the information submitted relative to the expenditure objectives set out in the Rules using a range of different techniques. These techniques could include a mix of bottom-up assessments of the proposal, top-down benchmarking, activity based analysis, a detailed review of a sample of projects and/or an expert review of costs.

Importantly, the AER would not be bound to focussing its assessment as to whether the proposal reasonably reflects the expenditure criteria. Instead, the AER could simultaneously be conducting rigorous testing of the proposal, while undertaking a range of other assessment techniques. As highlighted above, a key problem with the current regime is that it focuses on the assessment of 'reasonably reflects' first and then turns to consideration of what should be substituted if the total proposed is rejected.

A detailed assessment of the information provided by the business is still the starting point to this process. However, it ensures balanced decisions that all stakeholders can have confidence have been subject to rigorous testing and analysis.

Again, all of this would be bounded by the requirements in the Law and guided by a clear, consistent and transparent list of expenditure objectives and factors set out in the rules. This would allow the AER to weigh up all available information, evidence and data in order to reach a balanced decision on forecast expenditure. The result would be an impartial estimate of required expenditure. These proposals are not radical, but would place the regulation of the electricity sector back in line with normal regulatory practice in other countries and across other industries.