Energy Users Rule Change Committee
C/o Brian Green,
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Australian Paper
307 Ferntree Gully Road
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Mt Waverley
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8 December 2011

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Cc: Richard Khoe

Dear John,

Submission on AEMC consultation paper (ERC 0134)

The Energy Users Rule Change Committee representing Australian Paper, Amcor, Rio Tinto, Simplot, Wesfarmers/Coles, Westfield and Woolworths is very pleased to have the opportunity to make a submission to the AEMC's Consultation Paper on the changes to Chapter 6 and 6A proposed by the Australian Energy Regulator.

Committee members have become concerned about the outcomes delivered by the electricity network service providers (NSPs) operating in the National Electricity Market (NEM).

The objective of the regulatory framework and its price/revenue cap regulation of NSP's is to mimic the disciplines of a competitive market. The Committee believes that there is convincing evidence of poor cost control and excessive profitability for NSPs resulting from of a failure of this framework to meet this objective. The result is that all energy users pay significantly higher costs than would be the outcome in a competitive market.

The Committee has commissioned CME to survey the evidence of systemic failures and also to provide advice in relation to the ability of the AER's rule change proposals to address these systemic failures. Their report will also comment on the role of discretion and prescription in regulation and provide views on priorities, as you requested at the Brisbane Conference on 23 November 2011.

Unforeseen circumstances, as discussed with Paul Smith, has meant that it has not been possible to finalise CME's report by the 8th of December. This letter presages the CME report - which will be submitted shortly – and hopefully reassures you of our absolute commitment and interest in this review.

Yours sincerely,

B Green

Brian Green
Chairman of the Energy Users Rule Change Committee

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15 December 2011

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449, Sydney South NSW 1235

Dear John,

CME report on AEMC consultation (ERC 0134)

Further to our letter to you of 8 December 2011, we are pleased to send you a report by CME that we commissioned to provide analysis and views on the AER's rule change proposals. The CME report surveys evidence to substantiate the view that the system of economic regulation of NSPs in the NEM appears to have failed to deliver efficient outcomes at least in respect of government-owned network service providers (NSPs).

The members of the Rule Change Committee place particular importance on reliable electricity supply, but are concerned that some NSPs should be able to provide a reliable service more efficiently than they are now.

The CME report also reviews the AER's rule change proposals. The report is generally supportive of the AER's proposals particularly in respect of changes that re-establish the onus of proof on NSPs to demonstrate to the AER that their expenditure plans are efficient, rather for the AER to prove that they are not.

However the CME report calls upon the AEMC to take a wider-perspective than the AER has on the design of capex efficiency incentives. The CME report points to concerns over cost-shifting, moral hazard and rent seeking that the AER's proposals might lead to. They suggest that tighter penalties for over-spending regulatory allowances might be accompanied by tighter penalties for failure to meet reliability targets, rather than by mechanisms for NSPs to pass additional spending on to users.

The CME report does however reject the AER's proposals that all aspects of the Weighted Average Cost of Capital (WACC) should be left to the AER to determine through its periodic WACC reviews. The report suggests that the return on debt and risk free rate are amenable to clear specification in the Rules and suggests that it would be preferable that these aspects of the WACC should be specified in the Rules, rather than left to regulatory discretion.

We commend the CME report to your review and look forward to engaging with you on it in due course.

Yours sincerely,

Brian Green
Chairman of the Energy Users Rule Change Committee

Report to the Energy Users Rule Change Committee

National Electricity Amendment (Economic regulation of network service providers) Rule 2011 Consultation Paper

15 December 2011

EXECUTIVE SUMMARY

This document is a report to the Energy Users Rule Change Committee (RCC) representing Australian Paper, Amcor, Rio Tinto, Simplot, Wesfarmers/Coles, Westfield and Woolworths. The Committee has commissioned this report in response to the Australian Energy Market Commission's (AEMC's) Consultation Paper on the AER's rule change proposals.

The scope of this report is to:

- summarise the evidence that justifies changes to Chapters 6 and 6A of the Rules;
- describe and comment on the AER's proposals in terms of their ability to address the flaws in the current regulatory framework.

Context

Transporting electricity on the transmission and distribution networks of the National Electricity Market (NEM) is a significant, capital intensive, industry. In 2011 network service providers (NSPs) operating in the NEM will recover regulated revenues of around $10bn on regulated assets valued at $64bn. Government owned NSPs in Queensland, New South Wales and Tasmania account for around 75% of these regulated assets and serve around 60% of the nine million connections in the NEM, with the remaining services provided by privately owned NSPs in Victoria and South Australia.

For the typical electricity user, the charge for transporting electricity to its point of use is more than 50% of their electricity bill. This charge (and its proportion of the final electricity bill) has risen dramatically over the last five years and will continue to do so for the next five years following recent AER price/revenue control decisions. The members of the Rule Change Committee place particular importance on reliable electricity supply, but are concerned that some NSPs should be able to provide a reliable service more efficiently than they are now.

Is there a problem?

Analysis of NSP expenditures, revenues and prices shows that government-owned NSPs have spent considerably more to deliver services compared to their privately owned peers. This is true not just in respect of those NSPs regulated by the AER, but also those previously regulated by jurisdictional regulators.

Rising demand, ageing assets and historic underinvestment has been blamed, mainly by NSPs but also at times by regulators and governments, for significantly higher expenditure and prices. But closer analysis suggests that these are not adequate explanations. There is little if any evidence to substantiate the claims of historic underinvestment. Government studies suggest that opposite may be the case. And privately owned NSPs appear to have dealt with rising demand and ageing assets more efficiently than their government-owned peers. This suggests that the explanation for rising expenditure is not exogenous factors such as ageing assets and demand growth but rather the differing efficiency of the distributors in managing these factors.

Comparative benchmarking shows that the efficiency of government-owned distributors has declined significantly relative to their privately owned peers over the course of the three regulatory control periods that have applied to these distributors, so that government-owned distributors are now on average half as efficient as their privately owned peers. The system of economic regulation appears to have failed to deliver efficient outcomes at least in respect of government-owned NSPs.

Significant expansion in the regulated asset bases (particularly of government-owned distributors) has significantly boosted distributor profits. Analysis of the profitability of distributors shows that the NSW government achieved a 28.3% return on its investment after counting attributable profits, income tax equivalents and margins on debt sourced from the government treasury and on-lend to its distributors at a premium. This compares to a return on equity of 10.3% that the AER had calculated would be appropriate, in its price control decision of these distributors.

Significant institutions and individuals are persuaded of the existence of a problem, including the Australian Energy Regulator, the Independent Pricing and Administrative Tribunal, the Garnaut Review, Professor Parry, the Tamberlin Review and the Parry-Duffy Report).

What is the problem?

Ownership, the conduct of regulation and the design of regulation have been identified as three possible factors affecting the observed outcomes.

While there can be little doubt about the importance of ownership in explaining outcomes, in many cases it is difficult to establish the relative importance of the design of regulation and the conduct of regulation. Perhaps privatisation is necessary if significant efficiency improvements are to be achieved, as several analysts have suggested.

Never the less, it would be hard to dispute that improvements would be possible to the design and conduct of regulation without privatisation, particularly if there is more explicit recognition of the differences in incentives that arise under government and private ownership. The AER's proposals, although they do not deal with ownership, should be assessed on their merits.

Comment on the AER's proposals

Most of the AER's proposed changes to the Electricity Rules might be considered incremental. Nonetheless their potential impact should not be underestimated. A summary of the AER's proposals and a précis of our comment on them are set out in Table 1.

Table 1. Description and comment on the AER proposals

AER Proposal	Comment
Determination of opex and capex allowances 1. Remove the requirement that the AER has to accept an NSP's proposed opex or capex if it reasonably reflects the required expenditure; 2. Remove the requirement on the AER to determine an opex/capex allowance "based on" the distributor's proposal (applies to distributors only); 3. Deletion of most "expenditure criteria" including the criterion requiring the AER to have regard to the circumstances of the transmission or distribution NSP; 4. Re-ordering various expenditure factors and adding a "catch-all" factor so that the AER can consider any other factor that it wishes to.	These proposals appear to be well directed and address the inappropriate onus of proof in the current rules.
Capex efficiency incentives 1. **Strengthening the incentive not to overspend the allowance:** Only capex up to the forecast would be automatically added to the regulatory asset base. Forty per cent of capex in excess of the allowance would be funded by shareholders and the remaining 60 per cent would be borne by customers; 2. **Discretion to decide depreciation calculation:** The calculation of the closing regulatory asset base would be based on depreciation of the actual expenditure incurred or the allowed expenditure, with the choice at the AER's discretion. 3. **Re-openers:** DNSPs can apply to re-open regulatory decisions during the regulatory control subject to a $10m threshold (only applications to increase expenditure by more than $10m will be considered and the AER proposes that this trigger level will be amenable to change by the AER); 4. **Contingent projects:** DNSPs can propose "contingent projects" during the regulatory control determination. This would allow for a more-or-less automatic adjustment of the regulatory allowances if investment in those contingent projects proceeds during the regulatory control period; 5. **Pass-throughs:** NSPs can apply to pass-through certain additional costs subject to various criteria and a materiality test that those additional costs exceed 1% of regulated	Strengthening the penalty for overspending the capex allowance is well-directed, particularly for government-owned NSPs that have had a track recorded of significantly exceeding their capex allowances. However the AER's proposals to extend re-openers and contingent projects to DNSPs will weaken expenditure controls and increase risk of moral hazard, cost-shifting and rent-seeking. The AEMC should be encouraged to take a wider perspective on this issue and to propose and evaluate a variety of possible regulatory designs that may provide effective incentives to control expenditure by both government and privately owned NSPs. This could include approaches that discriminate incentive design on the basis of ownership, reflecting the differences in the cost of capital to government and privately owned NSPs. If the AEMC is minded to extend the contingent project and re-openers to DNSPs as the AER has proposed, we suggest that

revenues. 6. **Ex-post adjustment of the RAB:** in the calculation of the regulatory asset base at the end of the regulatory control period, the AER reserves the right to adjust the RAB to exclude the impact of changes in capitalisation policy or related-party margins.	the AEMC might consider additional protections against cost-shifting, rent seeking and moral hazard.
Determination of the Weighted Average Cost of Capital 1. withdrawal of the provisions in the Rules specifying the calculation of the return on debt, and in its place the AER should be allowed to determine the return on debt as part of its periodic WACC reviews; 2. withdrawal of the provisions in the Rules for the determination of the risk free rate; 3. withdrawal of the provisions (that apply only in Chapter 6) requiring the AER to vary the Weighted Average Cost of Capital (WACC) parameters from the values determined in its periodic WACC reviews if there is persuasive evidence to do this.	The AER's proposals will mean that the cost of capital will be determined by the AER through WACC reviews that it will run. We suggest that the risk free rate and return on debt should continue to be specified in the Rules, but consider that the AER's proposal to determine various cost of equity parameters through its WACC reviews has merit.
Procedural amendments and confidential information 1. NSPs be restricted from making submissions on their own revenue/price control proposals; 2. The AER should have discretion to apply less weight to information that NSPs claim confidentiality on (as it can with respect to information provided by other stakeholders).	These changes are well directed and should be supported.

Other issues

At the AEMC's Brisbane Forum, John Pierce, AEMC Chairman asked for comment on the issue of regulatory discretion versus prescription, and also on priorities.

The AER's proposal suggests that prescription (what it calls "the detailed codification of the methodology of economic regulation") has hindered its ability to "*appropriately*" regulate NSPs. Specifically it has claimed that such detailed codification:

"*has restricted the AER's ability to effectively balance the interests of both consumers and regulated NSPs when making regulatory determinations and hindered the AER's ability to respond flexibly to changing circumstances*".

The AER suggests that this has resulted in regulated prices higher than the level associated with efficient investment and operation by NSPs. [1] The AER is suggesting that there is a dichotomy between prescription (which it suggests is in NSPs interests) and discretion (which it suggests is in consumers' interests).

We partly agree with this description of the problem. A regulator should be properly empowered to undertake its duties, if it is to be held accountable for the outcomes. We suggest that this means that the AER must be able to make decisions "in-the-round" reflecting information and argument presented to it by the NSPs, but also its own critical assessment of such information and argument.

Often such critical assessment will rely on the exercise of judgement reflecting consideration of an NSPs' incentives (both in the construction of their regulatory proposals and in the subsequent execution of their activities).

While the AER should be accountable for providing clear and justifiable reasons for its decisions, many economic regulatory judgements are not reducible to arithmetic demonstration or variance analysis against an NSP's proposal. This is because in many respects the judgements involve consideration not just of technical information, but also of the incentives underlying the presentation of that information, and also how unknown and incalculable factors may affect future outcomes.

The design of the regulatory regime must ensure that the AER is empowered to make such judgements, without needing to present calculations to the NSP's satisfaction, or to explain these changes as variances against the NSP's proposals. If the AER feels unduly constrained in its ability to exercise discretion then relaxing such constraints may help to restore the AER's proper accountability, and the integrity of the system of economic regulation.

However, in a more general sense it is hard to see that prescription is *necessarily* in NSPs interests, and neither is discretion *necessarily* in consumers' interests, as the AER

[1] AER, September 2011. "Rule change proposal: Economic regulation of transmission and distribution network service providers", page 12.

has implied. For example if, hypothetically, a regulator more inclined towards NSPs was given greater discretion then they might be expected to deliver outcomes that would be even more favourable to NSPs, than would be the case if there were prescriptive rules that restricted the regulator's ability to do this. Attitudes to prescription and discretion will therefore depend on the perceptions of the regulator's inclination to users relative to NSPs.

As such, we suggest that describing the (general) problem as a dichotomy between prescription and discretion is not useful. Rather we suggest it is more helpful to distinguish between well-specified and poorly-specified prescription. Well-specified prescription might be expected to satisfy certain characteristics, such as it:

1. reduces regulatory risk to the benefit of NSPs and energy users;
2. lowers costs in the administration of regulation;
3. promotes regulatory accountability;
4. recognises the incentives established through the system of regulation and the NSPs response to those incentives.

Essentially, if an aspect of a regulatory framework can be clearly specified andif such specification reduces regulatory uncertainty and simplifies the regulatory process then it seems sensible that it should be specified in rules rather than left as a matter of regulatory discretion. Where this is not possible, prescription is unlikely to be useful assuming an unbiased regulator.

Priorities

In our opinion, the most important area in which the AER has proposed changes to the Rules, is in respect of the design of incentives to manage capital expenditure efficiently. Ideally the changes to the Rules that the AEMC approves will appropriately reflect the impact of ownership on investment incentives. Restoring the onus of proof on NSPs to convince the regulator about their expenditure proposals should also be a priority.

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1 Introduction

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The scope of this report is to:

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- comment on the AER's proposals in terms of their ability to address the flaws in the current regulatory framework.

Context

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For the typical electricity user, the charge for transporting electricity to its point of use is more than 50% of their electricity bill. This charge (and its proportion of the final electricity bill) has risen dramatically over the last five years and will continue to do so for the next five years following recent AER price/revenue control decisions. These rising charges have had a notable impact on inflation in many States. Outcomes in such a large element of the electricity industry can expect to have a measurable on consumer price inflation, the productivity of the Australian economy and the welfare of its people.

The members of the Rule Change Committee place particular importance on reliable electricity supply, but are concerned that some NSPs should be able to provide a reliable service more efficiently than they are now.

The NSPs are monopolies that are not subject to the competitive pressures in contestable industries. Consumers are forced to rely on economic regulation to ensure that NSPs invest and operate efficiently and are prevented from extracting excessive profits.

The evidence in recent studies (summarised in this report) is that some distributors deliver services at significantly lower cost than others, and also that allowed (regulated) revenues have increased significantly, particularly for the least efficient distributors. There is also evidence that Governments are deriving excess returns from their ownership of NSPs. This evidence suggests that the existing rules, amongst other factors, are failing to deliver effective economic control. All energy users – large and small – are paying the price for the consequential inefficiency.

Comments on issues arising at the AEMC's Brisbane Forum

In his opening remarks at the Brisbane Forum, AEMC Chairman John Pierce suggested that it is necessary to be realistic about the extent to which changes to the Rules can resolve concerns about increasing energy prices. This is accepted. In an environment of high resource costs, it is particularly crucial that investment in and management of energy networks is carried out as efficiently as possible. Regulatory design forthe AEMCis mainly responsible, is one part of the problem. Ownership and regulatory conduct also matter. Section 3 of this report explores these issues in greater detail.

Notwithstanding, regulatory design has a significant impact on the allocation of costs and risks between NSPs and consumers. This affects the dynamism of the regulated monopolies and can help to restore the requirement that they provide services *in the long term interest of consumers* (the National Electricity Objective). Even if this proves to be wishful thinking, at the very least regulatory design is capable of ensuring that shareholders, not consumers, bear the consequences of inefficient investment and operation.

At the Brisbane Forum, Mr John Pierce, also alluded to the fact that investors in network utilities have an international investment market and so Australian network utilities are required to compete in that market to attract investment. We agree with this, but note that the capital competition perspective would only apply in respect of the 25% of the NSP sector in the NEM that is privately owned (obviously the same competition for capital does not exist in the 75% of the industry that remains government-owned).

More generally however, the underlying message of Mr Pierce's comments – i.e. that a holistic perspective of NSPs performance is necessary in assessing changes to the rules - is valid. Pursuant to this, the AEMC should be encouraged to conduct comparative analysis into the difference between the regulated rate of return on debt and equity, and the actual rates of return that are achieved. The RCC in its proposal to the AEMC has already undertaken extensive analysis of the difference between the actual and regulated cost of debt. This could be the starting point in the AEMC's analysis. In addition, the AEMC could be encouraged to develop a comparative analysis of the efficiency incentives that apply in the economic regulation of electricity networks in other countries, with those that apply in the NEM. The data needed to do this is easily available.

Structure

The rest of this report proceeds as follows:

- Section 2 examines the evidence of a problem and then considers the nature of the problem;
- Section 3 comments on the AER's proposals.

2 Is there a problem?

At the AEMC's Brisbane Forum on 23 November 2011, representatives from Grid Australia and the Energy Networks Association suggested that there was no problem with regulatory design. Instead it was suggested that if the AEMC wished to deal with rising prices, it should find a way to deal with the increasing uptake of air-conditioners, historic underinvestment (which was blamed on over-zealous regulators in the past) and ageing assets. To the extent that the NSPs offered any recognition of regulatory problems, there was a reluctant acceptance by some that, perhaps, the debt risk premium was too generous. They also suggested that the AER failed to understand network businesses and that it was prone to errors that had to be corrected through appeals to the Australian Competition Tribunal (ACT).

The "rising demand, ageing assets, historic under-spending" troika of exogenous variables has been a consistent explanatory narrative from NSPs. Regulatory institutions and governments have also attributed outcomes to these factors in the context of politically unpalatable price control decisions. However in its rule change proposals it is notable that the AER has not suggested that any of these exogenous factors can explain the outcomes that have been observed.

This section examines the evidence of a problem and then attempts to define the nature of the problem.

2.1 Evidence

The idea that exogenous variables fully explain expenditure outcomes is appealing. It suggests that businesses, institutions and regulatory frameworks are working as they should and that the NSPs are responding efficiently to factors which at this point are, unfortunately, causing prices to rise. The evidence however suggests that this may be wishful thinking.

Research by Mountain and Littlechild first published through the Electricity Policy Research Group at Cambridge University in 2009 and subsequently in the journal, Energy Policy, in 2010[2] established initial evidence to question outcomes in distribution in the NEM. This initial research was subsequently extended in research commissioned by the Energy Users Association of Australia and published in May 2011.[3] This later research (the "Mountain Report") compared expenditure, asset values, regulated returns on a per connection basis amongst the distributors in the NEM. Some of its notable findings were that:

1. Between 2001 and 2011, government-owned distributors have increased their revenue collection per customer from around $600 per customer per year to around $1150 per customer per year. Privately owned distributors will have

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[2] Mountain, B.R., Littlechild, S. C., May 2010. *Comparing electricity distribution network revenues and costs in New South Wales, Great Britain and Victoria.* Energy Policy 38 (2010) 5770–5782

[3] Mountain, B.R., May 2011. *Australia's rising electricity prices and declining productivity: the contribution of its electricity distributors.* Energy Users Association of Australia, Melbourne.

remained approximately constant at $600 per customer per year over this period;

2. Between 2001 and 2011, the regulated asset base (RAB) per connection for privately owner distributors has remained approximately constant at $3000 per connection per year. The RAB per connection for government owned distributors has approximately doubled per connection from $4000 per connection to $8000 per connection over the same period.

3. Between 2001 and 2011, the capitalised expenditure per connection has risen from $200 to $300 per connection per year for privately owned distributors, and from $350 to $900 per customer per year for government owned distributors.

Mountain (2011) then compared predominantly urban and predominantly country distributors and found that the trends in expenditure, revenues and assets performance of government and private were comparable in both cases.. The research then examined the extent to which the claims made by NSPs (and at some points also by governments and regulators) that expenditure outcomes are attributable to rising demand, ageing assets and historic underinvestment, could be sustained. The research found that:

1. **Rising demand:** peak electrical demand has grown more strongly in Victoria than in Queensland (in absolute terms) and far more strongly (as an annual rate of growth) than in New South Wales[i]. Yet growth-related expenditure allowed by the AER has been four times higher per connection for government owned distributors in New South Wales and Queensland than for privately owned distributors in Victoria and South Australia. This suggests that the growth in peak demand is a poor explanation for the capital expenditure growth. Rather the main issue seems to be an inefficient response to demand growth by government owned distributors, approved by the AER, relative to their privately-owned peers.

2. **Ageing assets:** government owned distributors in New South Wales and Queensland have an effective weighted average remaining asset life of 31 years. The private distributors in South Australia and Victoria claim 22 years effective weighted average remaining asset life. If the replacement of ageing assets is an explanatory factor then it would be expected that privately owned distributors would be spending more to replace assets that are nearer the end of their lives. Yet the government owned distributors have been given regulatory allowances that result in them charging energy users four times more per connection to replace ageing assets, as the privately owned distributors. This suggests that asset ageing does not adequately explain rising expenditure. Rather, the main issue appears to be an inefficient response to asset ageing by government owned distributors, approved by the AER, relatively to their privately owned peers.

3. **Historic underinvestment:** the report found that the New South Wales Government and the Energy Supply Association of Australia commissioned studies in the 1990s concluded that NSW distributors were inefficient and their

capital productivity was poor. The synthesis report describing these studies was written by John Pierce (et al). The conclusion to be drawn from its analysis is that of historic over-investment, not under-investment, by NSW distributors. Since the time of those studies (up to 1995), expenditure by New South Wales distributors has consistently risen, not fallen, in absolute terms and per customer served.

4. In Queensland in 2004 the Independent Panel (otherwise known as the Somerville Review) concluded that under-investment explained poor service outcomes by Queensland distributors. But the service outcomes for Queensland's biggest distributor that serves three-quarters of Queensland's users were above the Australian average. For the other distributor, it is not clear that the problem was historic underinvestment rather than co-ordination and planning deficiencies following Government approved but apparently poorly executed mergers in the previous five years.

Instead of this troika of exogenous variables explaining expenditure outcomes, the Mountain report pointed to the role of ownership, the conduct of regulation, differences in asset valuation (between private and government owned NSPs), arrangements for appeal and regulatory design as factors that might explain the observed outcomes. The Mountain Report noted that ratios of the revenues or expenditures relative to customer numbers are strongly suggestive of differences in efficiency. But it is not possible to draw categorical conclusions from this, on the relative efficiency of the distributors. To be able to draw such conclusions, it is necessary to develop a systematic benchmark analysis using accepted econometric or statistical techniques. A variety of recognised methodologies are available to do this.

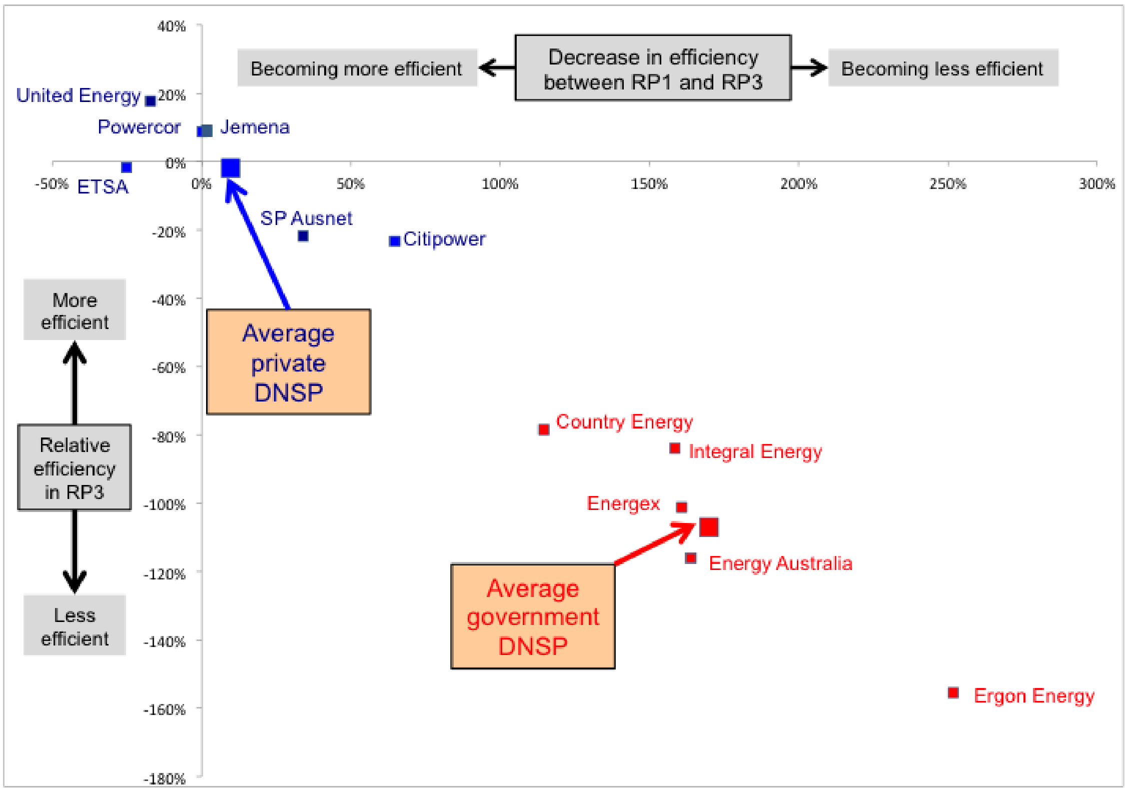
The Mountain report developed a regression analysis to benchmark the efficiency of the distributors. It regressed total annual expenditure against a composite scale variable consisting of line length and number of customers. The efficiency frontier was chosen to be the upper quartile level of performance. This was used to measure the relative efficiency of the 11 distributors operating in the NEM (excluding Aurora which had not yet been subject to economic regulation by the AER). This assessment was then replicated over the previous two and current regulatory control periods, and from this the relative change in efficiency of the distributors across the three regulatory periods (starting from around 2000 and ending in around 2015 – specific start and end dates vary amongst the distributors) was measured.

The results were then mapped so that the relative efficiency of the distributors in the third regulatory period (the regulatory period currently under way) was mapped against the change in the efficiency of the distributors between the first and third regulatory periods. This mapping provides information on the relative efficiency of the distributors in the regulatory period under way, and how this efficiency has changed over the three regulatory periods.

The results of this analysis are shown in Figure 1. In this figure, the y-axis shows the relative efficiency of distributors based on the expenditure allowances in the third regulatory period. This shows United Energy as the most efficient distributor and Ergon Energy as the least efficient distributor. It shows that the average performance of the privately owned distributors is at the upper-quartile of all distributors. By comparison, the average government owned distributor is around half as efficient as the average private distributor i.e. they incur around 100% more (twice as much) expenditure to deliver the same service as the average privately owned distributors.

The x-axis shows how the efficiency of the distributors has changed between the first and third regulatory periods. This shows that the average private distributor had remained at around the same level of efficiency in the first and third regulatory period. By comparison, the average government distributor will spend 150% more in the third regulatory period than in the first. A detailed description of the econometric analysis used in the this benchmarking can be found in Appendix A of Mountain (2011)

Figure 1. Benchmarking relative efficiency and changes across regulatory periods.



Several observations can be made from this analysis:

1. Government-owned distributors are on average half as efficient as their privately-owned peers;
2. Across the previous two and the most recent regulatory control period, the efficiency of privately owned distributors has remained approximately constant;
3. The efficiency gap between private and government owned distributors has grown significantly over time so that whereas they were comparably efficient at the start of the first regulatory control period, by the third regulatory control period the efficiency of government-owned distributors has declined significantly.

Of these three observations, the third is the most significant. The observation supports the conclusion that since the introduction of price cap/revenue cap regulation a significant gap has grown between the efficiency of the government and privately owned distributors, and this gap is being funded through higher prices paid by the users served by government-owned distributors than privately owned distributors. In other words, the system of economic regulation appears to have failed to deliver efficient outcomes at least in respect of government-owned NSPs.

The review of the evidence of a problem has to this point focussed mainly on expenditures, revenues and prices. Another perspective on NSP performance can be obtained from an examination of their financial performance. In this area, the RCC's rule change proposal noted the rates of return on equity from its distributors and retailers, based on data provided in the New South Wales Auditor General's report to the NSW Parliament.

This shows that the NSW Government realised a cash benefit of $1171m from its distributors and retailers in 2010 in the form of dividends, profits on taxes and margins on debt. While segmented accounting of distribution and retailing is not presented in these accounts, we suggest that around 90% of this cash will be related to distribution rather than retailing. Around half of this cash is dividend from attributable profits, with the remaining half split approximately equally between income tax and profit on debt sourced from the NSW Treasury and on-lend to the distributors. Expressed as a rate of return on equity, attributable profits delivered a 16.5% return on equity. A measure of the Return on Equity rose to 28.3% once the receipt of income tax and profit on debt is accounted for.

By comparison, the Australian Energy Regulator's expectation (in its 2009/10 price control decision) was that the NSW distributors would earn a return on equity of 10.29% in 2010. In other words, the NSW distributors are delivering a rate of return on investment that is almost three times higher than the Australian Energy Regulator had anticipated.

Finally, it should be noted that the NSW Government has projected that profits and dividends (and income tax equivalents on profits) from its NSPs are likely to increase significantly over the course of the current regulatory period, in response to a rapidly expanding regulatory asset base.

It might be argued that it is inappropriate to count the income tax as a return on equity and that the debt margin is compensation for risks that tax payers bear on the prospect that government-owned distributors may fail to repay their loans to the Treasury. On the first argument, the exclusion of income taxes on the basis of its classification as a tax and not profit is a semantic distinction that ignores the fact that the income tax is collected by the state government by virtue of its ownership of the NSPs, and so it should be properly classified as a return on equity. On the second argument, the appropriate question is what the level of compensation for the risk of failure should appropriately be. It is not clear that the presumed rate - around 220 basis points - is reasonable.

This profitability analysis has relied on data provided by the New South Wales Auditor-General's report. Similar data for Tasmania and Queensland has not yet been found and so similar profitability analysis for these NSPs has not been undertaken.
Other significant institutions, analysts and commentators have come to similar conclusions to those reached in Mountain and Littlechild (2010) and Mountain (2011). For example the Parry-Duffy report commissioned by the Government of New South Wales and which reported in December 2010, pointed to the scope for greater efficiency in the NSW NSPs to fund price reductions and concluded that:

"*dual and conflicting roles that government has as owner of the network businesses and as policy maker*".

The Parry-Duffy report then suggested that the resolution of this:

"*would enable a more coherent balancing of public policy objectives against the commercial objectives of the (network) businesses*" … and would also enable … "*a more appropriate consideration of the drivers for network expansion and upgrades that drive large increases in capital expenditure and operating costs*".

In plain language, Parry-Duffy's assessment appears to be that Government ownership of networks in NSW had affected expenditure decisions to Government's benefit but to energy users' detriment.

The Garnaut Update Report in 2011 concluded that flaws in the regulatory design, arrangements for the appeal of regulatory decisions and continued government ownership had led to excessive allowed returns which had in turn led to "*overinvestment in networks and unnecessarily high prices for consumers*".[4]

In June 2011, Professor Tom Parry, previously the Chairman of the Independent Pricing and Regulatory Tribunal, said that:

".. the fundamental role of incentives appears to be missing from regulation today. The regulator doesn't appear to accept that a business will drive all of its costs, including efficient financing costs, so that customers can share in those benefits. And some of the businesses, notably the government-owned businesses, are not demonstrating the same governance drivers that gives the regulator confidence that the incentive model will work. For incentive regulation to work, the owners and management of the regulated network need to actively seek out every opportunity to drive efficiency in all the costs of the businesses. Whether all of the government-owned businesses in NSW and Queensland (and Western Australia) have the same drivers that we saw in the 1990s and early 2000s is starting to be questioned. And if governance is not transparently aligned to efficiency incentives, then the Australian regulatory model is very close to broken. How to fix it? That is the billion-dollar question. Hopefully, policy-makers at state and national levels of government will re-engage with this critical area of micro-economic reform. They need to; there is substantial economic welfare at stake."

[4] Garnaut, R. 2011. "*Garnaut Climate Change Review – Update 2011, Update Paper 8: Transforming the electricity sector*". Pages 38 to 47.

In July 2011, the Independent Pricing and Regulatory Tribunal (IPART) expressed concern that:

"*network costs are higher than necessary, because of certain aspects of the current regulatory framework, including the economic regulation of networks under the National Electricity Rules (NER) and the standards for network reliability and security*."[5]

IPART then suggested that:

"*economic regulation aspects of the NER, including the placement of an unusually high burden of proof on the regulator, unbalanced rules for appeal and prescriptive approaches to determining the network businesses' returns, may bias decisions in favour of higher prices and inefficient outcomes*."[6]

In October 2011, the Tamberlin Report concluded that:

"*Overall, the evidence before the Inquiry tends to support the view that privatisation of the network businesses would lead to efficiency gains over time. This would result in more effective capital investment, which should result in a reduction in the charges permitted to be levied for the business in the next regulatory period.*"[7]

Finally, we understand that IPART completed a report on the productivity of the New South Wales distributors in 2010, for the Treasurer of New South Wales. We understand that this report examines the decline in the productivity of the NSW distributors, and that it may be publicly available soon.

The evidence summarised in this section suggests that there can be no doubt about the existence of a problem that merits thorough examination by the AEMC, and whose resolution is likely to demand serious reform. The next section examines the nature of this problem in greater detail.

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[5] IPART, June 2011. "*Changes in regulated electricity retail prices from 1 July 2011*", Draft Report. Page 82.
[6] Ibid.
[7] Tamberlin, October, 2011. "*Final Report of the Special Commission of Inquiry into the Electricity Transactions*". Page XX.

2.2 What is the problem?

Mountain and Littlechild (2010) identified ownership, the conduct of regulation and the design of regulation as three possible factors affecting the observed outcomes. On ownership they suggested that:

"*Privately owned companies can be expected to be more interested in maximising profit, and therefore more responsive to regulatory incentives that reward reductions in opex and capex. … Government-owned companies, while not indifferent to profit, can be expected to place greater weight on non-pecuniary pressures (including from consumers, employees, suppliers, politicians, government and the media). This is likely to make them more cautious about cutting manpower and other costs, and more sympathetic to increasing capital expenditure.*"

As noted in the previous sub-section, Garnaut, Parry, Parry-Duffy and Tamberlin all placed government ownership at the centre of their critique of outcomes i.e. that privatisation could be expected to deliver greater efficiency. Most of these also referred to the design and conduct of regulation, while the AER and IPART referred only to deficiencies in the design of regulation and did not comment on ownership.

While there can be little doubt about the importance of ownership in explaining outcomes, in many cases it is difficult to establish the relative importance of the design of regulation and the conduct of regulation in explaining the observed outcomes. Perhaps privatisation is necessary if significant efficiency improvements are to be achieved, as several analysts have suggested.

Nevertheless, it would be hard to dispute that improvements would be possible to the design and conduct of regulation without privatisation, particularly if there is more explicit recognition of the different incentives implied by ownership. On this basis the AER's specific proposals should be assessed on their merits, as the next section suggests.

3 Comment on the AER's proposals

This section sets out the RCC's comment on the AER's proposals. It comments firstly on the issue of discretion versus prescription which John Pierce has specifically sought comment on, as discussed at the Brisbane Forum. It then comments on the AER's proposals on the capex and opex framework, capex incentives and regulatory processes.

3.1 Discretion versus prescription

The AER's proposal suggests that prescription (what it calls "the detailed codification of the methodology of economic regulation") has hindered its ability to "*appropriately*" regulate NSPs. Specifically it has claimed that such detailed codification:

"*has restricted the AER's ability to effectively balance the interests of both consumers and regulated NSPs when making regulatory determinations and hindered the AER's ability to respond flexibly to changing circumstances*".

The AER suggests that this has resulted in regulated prices higher than the level associated with efficient investment and operation by NSPs. [8] The AER is suggesting that there is a dichotomy between prescription (which it suggests is in NSPs interests) and discretion (which it suggests is in consumers' interests).

This description of the problem is partially accepted. A regulator should be properly empowered to undertake its duties, if it is to be held accountable for the outcomes. We suggest that this means that the AER must be able to make decisions "in-the-round" reflecting information and argument presented to it by the NSPs and others, but also its own critical assessment of such information and argument.

Often such critical assessment will rely on the exercise of judgement reflecting consideration of NSPs' incentives (both in the construction of their regulatory proposals and in the subsequent execution of their activities).

While the AER should be accountable for providing clear and justifiable reasons for its decisions, many economic regulatory judgements are not reducible to arithmetic demonstration or variance analysis against an NSP's proposal. This is because in many respects the judgements involve consideration not just of technical information, but also of the incentives underlying the presentation of that information, and also how unknown and incalculable factors may affect future outcomes.

The design of the regulatory regime must ensure that the AER is empowered to make such judgements, without needing to present calculations to the NSP's satisfaction, or to explain these changes as variances against the NSP's proposals. If the AER feels

[8] AER, September 2011. "Rule change proposal: Economic regulation of transmission and distribution network service providers", page 12.

unduly constrained in its ability to exercise discretion then relaxing such constraints may help to restore the AER's proper accountability, and the integrity of the system of economic regulation.

We suggest that there are clauses in the Rules (chapters 6 and 6A) that unreasonably discriminate against the AER exercising its judgement. In particular:

- **Presumption in favour of the NSPs:** Chapter 6 (6.12.3(f)(1) and 6A (6A.13.2(a)(2) limits the AER's discretion to vary NSPs proposals by requiring the AER to adjust NSP's claims "on the basis of" the NSPs proposals.

- **Onus of proof:** (clause 6.12.2(ii)) sets specific methodological requirements that the AER needs to satisfy in demonstrating to DNSPs that they are wrong.

We support the AER's proposal to eliminate the restrictions imposed in Chapter 6 (6.12.3(f)(1) and 6A (6A.13.2(a)(2), and also suggest that Clause 6.12.2(ii) be examined.

However, in a more general sense it is hard to see that prescription is *necessarily* in NSPs interests, and neither is discretion *necessarily* in consumers' interests, as the AER has implied. For example if, hypothetically, a regulator more inclined towards NSPs was given greater discretion then they might be expected to deliver outcomes that would be even more favourable to NSPs, than would be the case if there were prescriptive rules that restricted the regulator's ability to do this. Attitudes to prescription and discretion will therefore depend on the perceptions of the regulator's inclination to users relative to NSPs.

As such, we suggest that describing the (general) problem as a dichotomy between prescription and discretion is not useful. Rather we suggest it is more helpful to distinguish between well-specified and poorly-specified prescription. Well-specified prescription might be expected to satisfy certain characteristics, such as it:

- reduces regulatory risk to the benefit of NSPs and energy users;
- lowers costs in the administration of regulation;
- promotes regulatory accountability;
- recognises the incentives established through the system of regulation and the NSPs response to those incentives.

Essentially, if an aspect of a regulatory framework can be clearly specified and if such specification reduces regulatory uncertainty to investors and users and simplifies the regulatory process then it seems sensible that it should be specified in rules rather than left as a matter of regulatory discretion. Where this is not possible, prescription is unlikely to be useful.

In the rest of this section, we apply this thinking in our comments on the AER's proposal to change the rules in respect of the opex/capex framework, incentive design, the treatment of the cost of capital and changes to regulatory procedures.

3.2 The AER's proposals for the determination of opex and capex allowances

The AER has proposed the following changes to arrangements for the determination of opex and capex allowances:

1. Remove the requirement that the AER has to accept an NSP's proposed opex or capex if it reasonably reflects the required expenditure;
2. Remove the requirement on the AER to determine an opex/capex allowance "based on" the distributor's proposal (applies to distributors only);
3. Deletion of most "expenditure criteria" including the criterion requiring the AER to have regard to the circumstances of the transmission or distribution NSP;
4. Re-ordering various expenditure factors and adding a "catch-all" factor so that the AER can consider any other factor that it wishes to.

The AER has suggested that the rules it seeks to change, encourage NSPs to propose higher levels of expenditure during the regulatory period than is likely to occur. The AER also suggests that the rules force the AER to develop a line-by-line assessment of an NSP's opex and capex proposal.

Fixing prices or revenues for a period of time – as is the case with the price/revenue cap regulatory model specified in the Rules - creates an incentive for NSPs to propose higher expenditure levels than they think likely. This is not an outcome of the specific rules that the AER has referred to, and neither is it likely that the AER's proposal to change these specific rules will change this incentive. Furthermore it is not clear that the existing arrangements necessarily force the AER into a line-by-line assessment of NSP expenditure proposals, as the AER has suggested. Nonetheless we suggest that the AER's proposed changes in this area merit consideration for the following reasons:

1. Removing the requirement on the AER to accept an NSP's proposal if it reasonably reflects the required expenditure is a sensible simplification of the Rules. If a proposal was reasonable, the AER can be expected to accept it, the AER does not need to be instructed to do so;
2. Removing the requirement to determine opex/capex allowances "based on" a distributor's proposal is a sensible change. For the reasons discussed earlier, restricting the AER to make changes based on distributors' proposals can be expected to have unreasonably restricted the AER's discretion, to NSPs' benefit and at consumers' expense;
3. Removing the expenditure criteria from the Rules is again a useful simplification. It is particularly valuable to delete the requirement that the AER have regard to the circumstances of the NSP. Such a requirement is at odds with the philosophy underlying price cap regulation (i.e. the purpose of the regulation is to mimic outcomes that would be delivered in competitive markets and in competitive markets consumers don't pay more to compensate for the competitive weaknesses of their service providers).

4. Adding a "catch-all" expenditure factor so that the AER can consider any other expenditure factor that it wishes to, is a sensible addition to the AER's discretion.

In summary, while it might be argued that there is more that the AER could do even within the current Rules, the AER's proposals are at the least a sensible simplification of the existing Rules. That the AER considers that these changes promote regulatory accountability is an added attraction. On this basis, their proposals should be supported.

3.3 The AER's proposals on incentive design

The AER has proposed several changes to the design of incentives to make these incentives more powerful – particularly in the circumstances that NSPs spend more than their regulatory allowances (as has typically been the case for government-owned NSPs). The AER's main proposals in this area are as follows:

1. **Strengthening the incentive not to overspend the allowance:** Only capex up to the forecast would be automatically added to the regulatory asset base. Forty per cent of capex in excess of the allowance would be funded by shareholders and the remaining 60 per cent would be borne by customers;
2. **Discretion to decide depreciation calculation:** The calculation of the closing regulatory asset base would be based on depreciation of the actual expenditure incurred or the allowed expenditure, with the choice at the AER's discretion.
3. **Re-openers:** DNSPs can apply to re-open regulatory decisions during the regulatory control subject to a $10m threshold (only applications to increase expenditure by more than $10m will be considered and the AER proposes that this trigger level will be amenable to change by the AER);
4. **Contingent projects:** DNSPs can propose "contingent projects" during the regulatory control determination. This would allow for a more-or-less automatic adjustment of the regulatory allowances if investment in those contingent projects proceeds during the regulatory control period;
5. **Pass-throughs:** NSPs can apply to pass-through certain additional costs subject to various criteria and a materiality test that those additional costs exceed 1% of regulated revenues.
6. **Ex-post adjustment of the RAB:** in the calculation of the regulatory asset base at the end of the regulatory control period, the AER reserves the right to adjust the RAB to exclude the impact of changes in capitalisation policy or related-party margins.

The design of regulatory incentives is a complex but important subject. It merits detailed consideration.

Strengthening incentives not to overspend

There is little doubt that the regulatory incentives established by the AEMC provide weak incentives to reduce capital expenditure below the regulatory allowances. The existing incentive scheme provides a financial incentive to spend above the regulated expenditure allowances if the allowed rate of return is greater than the actual cost of capital. We suggest that this is likely to be the case for government-owned NSPs for a number of reasons including excessive allowed rates of return on debt, and state government receipt of income tax equivalents on the profits delivered by their NSPs.

Monte-carlo simulation of the regulatory incentives established in Chapter 6A by Mountain-Nuttall Consulting in 2005, and which was included in the ACCC's submission to the AEMC in the Chapter 6 review, concluded that it was likely that NSPs would over-spend their allowances because the incentives to reduce capital expenditure below the regulatory allowances were too weak.

This is indeed exactly what has occurred with the government-owned TNSPs to which this regime applied, and also the government-owned DNSPs under similar regimes applied by the Queensland Competition Authority and Independent Pricing and Regulatory Tribunal (IPART) in their previous regulatory control periods. Similar regulatory incentives applied by the Essential Services Commission of South Australia and the Essential Services Commission in Victoria did not however result in overspending by distributors in South Australia and Victoria. This suggests that the incentives have been too weak to constrain spending by government owned distributors, but not too weak to constrain expenditure within the regulatory allowances, for privately owned distributors.

This historical experience suggests that the AER's proposal to strengthen the penalty to be faced by NSPs for capex above their regulatory allowance is well directed. The AER's proposal that shareholders bear 40% of the overspend (and consumers the remaining 60%) is arbitrary, as indeed would be any other split. An important factor in choosing this split would be whether it is sufficiently large as to provide an adequate discipline on NSP expenditure, particularly by government-owned NSPs. Our initial view is that the proposed 40/60 split should provide an adequate discipline on NSPs to spend within their regulatory allowances. However this merits more detailed assessment having regard also to the AER's treatment of depreciation, ex-post adjustments for changes in capitalisation policy and related-party margins and also other aspects of the incentive design, discussed further below.

Depreciation calculations

The AER's proposal that it should have discretion to decide the basis upon which it calculates regulatory depreciation (using either proposed or actual expenditure) should be considered further. An important consideration in incentive design is ensuring that investors and managers understand the incentives that they operate under.

To provide such certainty we suggest it would be better to settle on one or the other basis for the calculation of regulatory depreciation, rather than leave it to the AER to decide in each regulatory decision. On the basis of the AER's stronger incentive not to overspend the regulatory allowances, we suggest that the appropriate choice would be to calculate the value of the regulatory asset base using the depreciated value of the actual expenditure during the regulatory period.

Contingent projects, pass-throughs and re-openers

The remaining elements of the AER's proposals on the design of incentives are less attractive. While the AER proposes to strengthen the penalties faced by NSPs for overspending regulatory allowances, it has included provisions for the regulatory decision to be re-opened (by NSPs only), and for contingent projects to be specified by DNSPs (they already apply to TNSPs) in addition to the existing cost pass-through arrangements.

These "contingent projects", "pass-throughs" and "re-openers" have the potential to provide other ways in which NSPs may recover expenditure from consumers, other than through price/revenue cap established in the main price control. Presumably the AER was minded to bolster these additional provisions on the basis that if it did not do this, NSPs might not be able to meet their reliability targets if future expenditure requirements turned out to be less benign than expected at the time of the main price/revenue control determination.

However, there are other ways that the AER might ameliorate its apparent concern about reliability of service provision associated with its proposal to toughen the penalty for overspend. For example, instead of allowing additional forms of expenditure approval, the AER might, strengthen service standard incentives so that NSPs suffer material financial losses if they fail to meet reliability performance standards. In this way, tighter expenditure discipline need not jeopardise service quality or reliability.

The additional expenditure approval mechanisms that the AER has proposed weaken incentives on NSPs to control their expenditure (why bother to constrain expenditure if you can just apply to the AER for a contingent project, pass-through or re-opener). These mechanisms also increase moral hazard, encourage cost shifting and reward rent-seeking. By effectively extending the regulatory decision-making process from periodic determinations to what might turn out to be continual review, this will put even greater pressure on already under-resourced end-user advocacy.

The intra-regulatory period adjustment mechanisms that the AER has proposed undermines the intent of price-cap regulatory controls i.e. to fix prices/revenues for a defined period of time and through this, establish incentives for TNSPs to efficiently reduce expenditure and thereby improve profits (with the benefit of such expenditure reductions being shared with consumers through price reductions in subsequent regulatory control periods).

The evidence in the previous section suggests that price cap regulation has not been successful in the economic regulation of government-owned NSPs. Therefore alternative approaches merit detailed consideration.

The AER's proposals are perhaps best characterised as adjustments to an existing scheme. The AER has not taken a wider perspective by considering a wider variety of different regulatory designs.

The AEMC should be encouraged to take a wider perspective on this issue and to propose and evaluate a variety of possible regulatory designs that may provide effective incentives to control expenditure by both government and privately owned NSPs. This could include approaches that discriminate incentive design on the basis of ownership, reflecting the differences in the cost of capital to government and privately owned NSPs.

However, if the AEMC is minded to extend the contingent project and re-openers to DNSPs as the AER has proposed, we suggest that the AEMC might consider additional protections against cost-shifting, rent seeking and moral hazard. This might be achieved through:

- Some form of "excess" so that NSPs are required to absorb the first several million dollars of any claim, before additional allowances associated with contingent expenditure; pass-throughs or re-openers are reflected in regulated charges;
- Restricting the ability of an NSP to apply for a re-opener or contingent project only if the total capex and opex during the regulatory period has exceeded the allowed capex and opex for the period. This would expose NSPs to the disciplines in competitive industries where unforseen but necessary expenditure causes a business to reassess which projects it would actually complete within its budget.

3.4 The AER's proposals on the cost of capital

The AER has proposed:

1. withdrawal of the provisions in the Rules specifying the calculation of the return on debt, and in its place the AER should be allowed to determine the return on debt as part of its periodic WACC reviews;

2. withdrawal of the provisions in the Rules for the determination of the risk free rate;

3. withdrawal of the provisions (that apply only in Chapter 6) requiring the AER to vary the Weighted Average Cost of Capital (WACC) parameters from the values determined in its periodic WACC reviews if there is persuasive evidence to do this.

The AER's proposal on the specification of the return on debt can be contrasted with the RCC's proposal that the regulatory determination of the return on debt should be specified in the Rules, based on the RCC's recommended formulation.

The RCC's rule change proposal sets out in detail why the RCC considers that the Return on Debt should be specified in the Rules rather than being left to be determined in periodic reviews by the AER. In summary, the RCC suggested that

1. Firstly, the AER's historic performance on WACC issues suggest that an AER review would not necessarily deliver an appropriate methodology or parameters for the Return on Debt.
2. Second, the AER has proposed that several clauses currently in the Rules that affect the calculation of the return on debt should remain. These include the requirement that the rate of return should be a forward looking rate of return commensurate with prevailing conditions in the market for funds, and the need for the return on debt to reflect the current cost of borrowings for comparable debt. The RCC considered that a return on debt established in accordance with these principles will not satisfy the NEO.
3. Third, the AER has proposed that the return on debt should continue to discriminate in favour of government owned NSPs by assuming - obviously falsely - that they are privately owned. This fails to recognise their lower cost of debt and the returns that governments are achieving through income tax equivalents on distributor profits.
4. Fourth, the Committee is not convinced by the AER's argument that regulatory discretion is valuable or preferable in the specification of the return on debt. Unlike most other elements of the WACC, the cost of debt is observable with reasonable certainty. In other countries the regulatory approach to the determination of the return on debt has been stable over long periods of time. These characteristics make it amenable to clear specification in terms of both methodology and parameters.
5. Finally, with the AER's approach, the RCC suggested that consumers will need to scrutinise each WACC review that the AER undertakes for the calculation of the return on debt as well as return on equity. Opportunities to reduce the scope of on-going, repeated consultation by setting the determination of the return on debt in the rules (as the RCC proposes), will reduce the need for repeated consultation and hence help to reduce advocacy burdens on consumers. It will also diminish opportunities for lobbying from well-resourced NSPs who can recover the costs of their lobbying through regulated charges.

For these reasons, the RCC concluded that the important issue is to ensure that the return on debt methodology is well designed and that the values that the application of that methodology delivers, properly accounts for the evolution in debt markets and NSP lending practices. The Committee suggests that this should be the focus of consideration by the AER. There is no compelling reason, on the basis of regulatory discretion, for consideration of the Committee's arguments to be deferred to an AER review. On the contrary, as discussed in the previous points there is good reason not to do this.

We agree with the RCC's reasoning and conclusions and on this basis suggest that the AEMC should reject the AER's proposals that the determination of the return on debt should be left to the AER as part of its periodic WACC reviews.

The remaining issues are whether to support the AER's proposals:

- to change Chapter 6 (to withdraw the requirement to revisit various WACC parameters in each price determination if there is persuasive evidence to do so);

- that the specification of the risk free rate be taken out of the Rules (both Chapter 6 and Chapter 6A) and left to the AER's WACC review.

Withdrawal of "persuasive evidence" requirement to revisit WACC parameters

On the first these, the argument for a retention of the "persuasive evidence" provision is that this allows WACC parameters to be revisited during each price/revenue control decision if conditions change so that the values determined in the AER's periodic WACC reviews are no longer appropriate. Assuming that the AEMC accepts the RCC's proposal that the return on debt is specified in the Rules (and also our recommendation below that the determination of the risk free rate should be specified in the Rules), the "persuasive evidence" provision would therefore apply to the determination of parameters that which will continue to be determined in AER WACC reviews (i.e. the cost of equity parameters - such as beta, gamma, the market risk premium and the gearing assumptions).

It would be beneficial to revisit WACC parameters in each decision if they are found to be inappropriate at the time of that decision. The AER has argued that WACC parameters (the AER refers to all WACC parameters) are stable over time, and hence it is unnecessary to revisit the parameters at each decision. The AER argues that its periodic (5 yearly) WACC reviews will set appropriate WACC parameters for all decisions it will make in the following five years. Since these regulatory decisions also typically last for 5 years, this means that the AER could be setting the WACC parameters in its periodic WACC reviews that would apply up to 10 years into the future. We agree with the AER's stability argument in respect of the cost of equity parameters such as the market risk premium, beta, gamma and gearing assumptions. However we suggest the stability argument on other parameters such as the risk free rate or cost of debt is not appropriate since these can change quickly depending on capital market conditions.

The AER's proposals will also reduce the opportunity for merits review of WACC decisions. If there is no requirement to examine persuasive evidence of changes in WACC parameters at the time of each decision, there will be less opportunity to appeal against AER WACC decisions since the AER will (in its proposals) establish all WACC parameters through its periodic reviews (which are not subject to merits review).

The "persuasive evidence" clause has enabled NSPs to appeal some AER WACC parameter decisions to the Australian Competition Tribunal (ACT), for example on Gamma (a parameter related to the franking credits attached to dividends).

The ACT's decisions on WACC (both on Gamma and a previous decision on the averaging period for the risk free rate – an appeal by NSW distributors, TransGrid and Transend - have been controversial not least in view of their impact on electricity prices. The ACT did not know (and hence did not consider) the impact of its decision on electricity prices in respect of either the value of Gamma or the averaging period for the risk free rate.

There is reason to be concerned about the ACT's ability to effectively review the AER's WACC decisions: how could the ACT have assessed whether its decision met the National Electricity Objective (the long term interest of consumers) if it did not know what effect its decision would have on electricity prices? For this reason, if none other, we suggest that the AER's proposals to eliminate the "persuasive evidence" clause from Chapter 6, and with it the scope of the ACT's review of some of the AER's WACC decisions, is well directed and should be supported by the RCC.

Withdrawal of the specification of the risk free rate in the Rules

The current specification of the risk free rate in the Rules is problematic. This issue is described in further detail in the RCC's proposals (see pages 24 to 25 of the RCC's proposals). The AER's proposal that the specification of the risk free rate be taken out of the Rules could therefore offer the opportunity for a more appropriate specification of the risk free rate through the AER's WACC review. This may offer a more expeditious solution to remedy the existing flaws (than a proposal to change to the rules, which would otherwise be required to remedy the flaws). The prospect of a more expeditious solution argues in favour of supporting the AER's proposal.

On the other hand, the fact that the risk free rate is written into the Rules means that energy users are able to propose to the AEMC that it be changed. This would not be possible if the AER determined the specification of the risk free rate through its WACC review.

The benefit of a possibly more expeditious change to the calculation of the risk free rate (through the AER's periodic WACC reviews) has to be set against the fact that energy users have no specific role in such reviews and are not able to propose changes to the AER's determination in the way that they are able to propose changes to the Rules.

On balance, and taking account of the fact that the risk free rate is amenable to clear specification in the rules, we suggest that the AER's proposal to withdraw the specification of the risk free rate from the Rules should not be supported.

3.5 The AER's proposals on procedural amendments and confidential information

The AER has proposed that:

- NSPs be restricted from making submissions on their own revenue/price control proposals;

- The AER should have discretion to apply less weight to information that NSPs claim confidentiality on (as it can with respect to information provided by other stakeholders).

The proposed changes means that NSP would no longer be allowed to make submissions on their own initial proposal, the AER's draft decision, or their own revised proposal. NSPs can respond to the draft decision through their revised proposal (and not through submissions or through a combination of their revised proposal and submissions). The proposed rules would also require the AER to not consider new information in a NSP's revised proposal which goes beyond responding to the draft decision.

The AER's proposals on procedural amendments and limiting the weight to be placed on confidential information are sensible. The AER provided clear evidence of strategic behaviour by NSPs – particularly DNSPs - in their provision of information to the AER. Such strategic behaviour contravenes the standards expected of a transparent and accountable regulatory process and the AER's proposals to deal with this seem to be a reasonable and proportionate response. Similarly placing less weight on confidential information provided by NSPs (as the AER does with respect to confidential information provided by other stakeholders) will help to provide appropriate incentives on NSPs to not abuse the opportunity to provide information in confidence to the AER.