

Submission to the AEMC

20 October 2006

Australian Government Solicitor Advice on Assessment of Expenditure Forecasts

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to respond to the AEMC regarding the Australian Government Solicitor's (AGS's) advice on the assessment of expenditure forecasts under its Draft Transmission Revenue Rule.

APIA has provided evidence in support of a propose-respond framework with a reasonableness test as the decision criterion throughout the energy regulatory reform process undertaken by both the AEMC and the Ministerial Council on Energy. We believe that this approach would deliver better regulatory outcomes as it would enable regulated businesses to design proposals which reflect individual circumstances, while ensuring overall regulatory objectives are met through the regulator being able to reject a proposal that does not meet the criteria established in the Rules. In view of the potentially significant consequences of and potential for regulatory error, we believe that this decision-making framework reflects the most prudent regulatory approach. Moreover, it is one which would be most efficient and effective and reduce the scope for appeals.

This framework has demonstrable advantages over an alternative consider-decide framework in terms of providing confidence to industry to invest in infrastructure assets. This is because it would provide greater certainty that a service provider's forecasts which represent its reasonable estimates in the prevailing circumstances would be accepted by the regulator. The inherent uncertainty with such forecasts materially increases regulatory risk - accordingly, focusing the regulator's investigation (at least initially) on the *reasonableness* of the submitted values reduces that regulatory risk. A regulator-determined 'optimum' value may instead underestimate the required level of expenditure. Given the scale and long-term nature of infrastructure investments, this should be a critical consideration for the AEMC.

APIA therefore considers that the AEMC's adoption of a 'reasonable estimates' test in regard to capital and operating expenditure forecasts is soundly based on the evidence and submits that the AEMC should not change its position as it finalises the draft rule. APIA's view is that this may be capable of being extended to a broader range of

variables in a regulatory determination to assist the effectiveness of the propose-respond framework. Any attempts to move the decision making framework further away from a genuine propose-respond model by removing the reasonable estimate decision rule would be an adverse development from the perspective of establishing a regulatory framework that is supportive of efficient investment in infrastructure.

This issue is of particular concern to the gas transmission industry, which has operated under a form of propose-respond for several years under the Gas Code and has a body of legal and regulatory precedent within this framework to draw on in facilitating appropriate regulatory outcomes. While the AEMC's draft rule applies only to electricity transmission, we are concerned that rules developed as part of this process with electricity in mind may potentially, in time, be applied to gas transmission without adequate consideration of the differences between the two industries which justify different regulatory treatment. We note in this regard that the AGS advice is concerned with electricity transmission and distribution; however, it notes that it may be relevant to similar issues in gas regulation.

It is in this context that APIA provides the following comments on the AGS's advice. In particular, APIA would like to reiterate to the AEMC that the considerable differences between electricity and gas transmission provide even greater justification for application of a 'reasonable estimate' decision rule over one based on 'best estimate' and to outline its concerns about the AGS's advice in regard to the reasonableness test.

Differences between gas and electricity transmission

It is important to the gas transmission industry that policy and rule making bodies such as the AEMC fully appreciate the differences in the underlying economic and operational characteristics of the gas and electricity transmission industries. While recognising that there is a desire among some policy makers to have consistent regulatory arrangements for energy infrastructure, this should not be pursued where there are good policy reasons that justify different treatment. Differences between gas and electricity infrastructure include economic, physical and market differences. These differences are reflected in current regulatory arrangements and should be maintained.

Investment in gas pipelines is market driven and is underpinned by bilateral contracts. The gas transmission industry differs from electricity in this regard. Electricity transmission investment is, typically, more centrally planned, developed incrementally at low risk, with large numbers of direct and indirect customers and recovered through averaged network charges. The investment drivers and processes of both transmission industries may also be coloured by the fact that almost all gas transmission is privately owned, whereas there is considerable government ownership of electricity transmission.

Further, gas transmission pipelines typically have few customers, usually with specific demands, and pipelines have considerably more scope to tailor their services to specific

customer requirements. This means that more invasive regulation has the potential to impact far more negatively on the gas transmission sector than on the electricity transmission sector. Intensive regulation of gas transmission is more likely to discourage innovation in gas transmission service offerings than in electricity, for example, where it imposes standardised return/risk arrangements to service offerings.

In terms of physical differences, a key difference is that gas pipelines can also act as storage vessels for gas, allowing demand variations to be met by stored supply. This contrasts with electricity, where flows must be instantaneous. Further, gas transmission is typically a point-to-point pipeline, whereas electricity transmission is a multi-directional network. This is why electricity dispatch entails a degree of coordination which is not required by gas.

The market operations of electricity and gas also differ, with the electricity grid operating as an integrated network and playing a key role in facilitating competition among generators (through interconnectors), providing an additional source of competition (with localised electricity generation) and underpinning dispatch. Gas market operations are driven by bilateral contracting arrangements.

These differences are fundamental and have significant implications in terms of developing an appropriate regulatory framework for gas transmission. In particular, the more invasive forms of regulatory control that apply to electricity transmission and distribution are not warranted in gas.

‘Reasonable estimate’ versus ‘best estimate’

The questions in the AGS advice indicate that there may be a concern in some quarters that the ‘reasonable estimate’ test as proposed in the draft rule does not provide the regulator with sufficient discretion to reject what it considers to be an inefficiently high estimate put forward by a business. It would appear that the AEMC is now considering an alternative formulation, namely a ‘best estimate’ test which would require the regulator to determine, in its view, an ‘optimum’ value.

APIA believes that, in much of the recent debate on this issue of discretion, there has been some confusion between three related factors:

- *the decision making framework* – this is the ability of a regulated business to submit a proposal for the regulator’s consideration and decision, ie. this is a propose-respond model in a process sense;
- *the decision making rule/criteria that the regulator must adhere to* in assessing a proposal – for example, a ‘reasonable estimate’ or a ‘best estimate’; and
- *the overall level of prescription/discretion* that the rules permit both the regulator and the regulated business. This is determined by the level of prescriptiveness in the rules, with the available discretion divided between the AER and the regulated business.

APIA maintains its view that the overall level of prescriptiveness in the draft rule is excessive, unduly constraining both the AER and regulated businesses. The rules unnecessarily constrain the proposal that a business may put forward and, as such, is not a genuine propose-respond model. This prescriptiveness will result in a less flexible regime than is appropriate for gas transmission and which may preclude economically sound and reasonable alternative approaches.

In terms of a decision-making rule, APIA believes that a reasonableness test would deliver better regulatory outcomes. The key point is that this approach recognises that there is unlikely to be a clear 'best estimate' of a particular parameter value, but rather reasonable values that may be derived from different methodologies and different assumptions, all of which have a high degree of validity. A decision-making rule - such as the 'best estimate' rule - that allows the regulator to substitute its own preferred estimates over the reasonable estimates of the service provider, will considerably increase the risk of regulatory error, with potentially significant disincentives for long-term investment in infrastructure assets.

A 'best estimate' rule applied within a propose-respond framework will be so constrained as to approximate a 'consider-decide' model in that it places the regulator in the position of determining its own estimate of the 'correct' or optimal value of particular parameters. It has been widely acknowledged that it is not possible for either the service provider or the regulator to determine the correct value for certain parameters, in particular, capital and operating expenditure forecasts, as these are subject to considerable forecasting uncertainty, particularly when the requirement is to determine costs that are efficient and prudent. The reality is that efficient costs cannot be determined with certainty. This means that determining the 'best estimate' is nearly as difficult to determine and is also subject to uncertainty. The decision-making rule needs to reflect this fact if it is not to run the considerable risk of regulatory error, which may be costly to the regulated business and the economy and community more generally where incentives to invest are undermined. Moreover, as the regulator may determine that the service provider's proposal does not reflect 'best estimates', it would then be bound to determine the 'best estimate', a judgement that would open it up to serious questions and significant potential for disputation and appeals.

APIA believes reasonable estimates are unlikely to be found in a broad band. Consequently, concerns that an obligation on the regulator to accept a reasonable position would result in excessive capital and operating expenditure being approved are misplaced. Under this decision-making rule, the regulator retains the ability to make an assessment of whether a proposal is reasonable and to reject it if not believed to be reasonable. That the regulator retains the ability to reject a proposal considered to be unreasonable is clear from the legal precedent that has been established in, particularly, the Telstra case cited in the advice. There is no basis for assuming that the regulator is in a better position than the service provider to determine which value within a reasonable range is optimal.

APIA believes that a decision-making rule that results in the approval of what is accepted by the regulator as a reasonable estimate is a fundamental element of a regulatory framework that is supportive of efficient investment in essential infrastructure. Accordingly, APIA urges the AEMC to retain the 'reasonable estimate' decision-making rule for capital and operating expenditure forecasts.

The handling of this issue has implications for the credibility of the rule-making process. The AEMC has undertaken an extensive consultation process and assessment and has presumably arrived at the conclusion that a reasonableness test in the context of the draft rule is appropriate. The experience with this test, including legal precedents, indicates that it does not prevent the regulator from rejecting an estimate that it does not consider to be reasonable. Moreover, the Expert Panel considered this issue and recognised propose-respond with a reasonableness test as a legitimate model, recognising as part of its recommendation on a 'fit-for-purpose' approach that it may be appropriate in certain cases. In light of this, it is of great concern that the AEMC may seek to dilute this provision at this stage of the process in favour of granting the regulator a significantly greater discretion under a 'best estimate' rule.

AGS advice

APIA has some concerns about the AGS's advice on the question of a reasonableness test for capital and operating expenditure – in particular, we are concerned about the nature of the advice and the use to which it will be put. As it would appear to be a significant input into the AEMC's development of this aspect of the draft rule, APIA believes that there should be greater clarity as to the intended purpose of this advice.

The AEMC is seeking comment in relation to whether a reasonableness test reversed the onus of proof. This is not the case under this decision rule – instead the regulator is merely being required to address a different question. That is, under a reasonableness test, the question the regulator must ask is whether the submitted value is reasonable in the circumstances. APIA submits that the question put by the AEMC is a significantly better formulated question because it addresses the essential issue at hand, namely the inherent limitations of regulatory decision making.

APIA has concerns that in some elements of the advice the AGS appears to be providing policy and regulatory advice in its overview and assessment of the issue. For example, based on discussions and consultations conducted as part of the recent policy debate, including the report by the Expert Panel, it defines a number of distinct decision-making models - namely pure propose-respond, pure consider-decide and limited propose-respond and limited consider-decide. While some of these terms have been widely used in the recent policy debate, in practice they are not clearly defined models which may be relied upon, by regulated businesses, the AEMC or the AER, in a practical or a legal sense. In fact, the AGS's discussion on propose-respond versus consider-decide presents as an authoritative position on what is, in fact, a development of its own theories of regulatory decision-making frameworks.

The AGS also notes that, even with the list of 12 factors the AER is to take in to account in assessing reasonableness, there will still be uncertainty. The AGS notes that the AER will be assisted by the NEL objective and pricing principles in resolving this uncertainty. In this regard, the AGS states that “...*generally the pricing principles place considerable weight on protecting the interests of service provider*”. This is an assertion that is not justified or supported by legal argument. The fact is that it is a matter of economic expertise and the AGS’s assertion can be shown to be incorrect. Moreover, the new NEL and NGL objectives recently approved by the MCE place precedence on the interests of consumers. Therefore, APIA believes that this assertion should not be relied upon by the AEMC to ensure that the reasonable forecasts of industry will be accepted.

In addition, APIA is concerned that some of the questions indicate a predisposition to achieve a determined end. For example, question 6 asks:

“Would a formulation that required the AER to determine whether the total was the ‘best estimate that is reasonably possible in the circumstances’ result in greater discretion for the regulator to reject proposals that it considers to be inefficiently high?”

The formulation of this question suggests a desire to construct a decision-making rule that maximises the discretion of the regulator to reject a proposal which, by some unspecified rule, it has decided is ‘inefficiently high’. Surely the most important consideration is to construct a rule that results in the approval of estimates of capital and operating expenditure that are reasonable in the circumstances. As noted above, APIA strongly believes that the ‘reasonable estimate’ rule is more likely to achieve this outcome than a ‘best estimate’ rule given the inherent uncertainty attached to these estimates and the widely acknowledged reality that a range of possible values will most likely be reasonable. Adopting the decision making rule most likely to achieve an outcome that is consistent with the overriding objective of the regulatory framework should be the primary consideration, and not which rule provides greatest discretion to the regulator.

In summary, APIA is concerned that this AGS advice might be relied upon as a point of reference in AEMC rule making and in future AER decisions. In particular, APIA has concerns that, at some points, the advice is more akin to policy or regulatory advice in its overview and assessment of the issues. Moreover, the nature of the questions appear to reflect a predisposition towards achieving a certain outcome, namely to maximise the discretion of the regulator. In view of these flaws, APIA is concerned about the implications of this advice forming a key point of reference in the development of the new regulatory arrangements.

The AEMC has asked whether the draft rule places an onus of proof on the TNSP or AER. The draft rule in fact places an onus on both the TNSP and the AER. The TNSP must present ‘reasonable estimates’ of capital and operating expenditure and support them with data, analysis and reasoning. The onus is then on the regulator to assess the

reasonableness of these estimates using the information provided by the TNSP and other sources as set out in the 12 facts to be considered. There is no weight of onus on either party. As noted above, the different decision rule simply means the regulator is required to ask a different question.

The AEMC has also asked whether the rules would operate to create a presumption in favour of acceptance of the TNSP's proposed forecast expenditure, if the AER was satisfied that the proposal met the criteria contained in the revenue rules. APIA does not believe that the rules create a presumption in favour of accepting anything. They presume that the TNSP will put forward its proposed costs which, if they are to be accepted by the AER, must be reasonable estimates. There is no automatic presumption that the costs proposed will be accepted. The requirement (rather than presumption) is that the AER will properly assess them as being reasonable or otherwise. In effect, for both the TNSP and the AER, it is a matter of compliance with the rules, and not a presumption.

Accordingly, APIA considers that a TNSP's proposal must be accepted if the AER is satisfied that the forecast expenditure satisfies the criteria in the rules.

Conclusion

APIA is strongly of the view that the AEMC should retain the 'reasonable estimate' decision criterion in regard to capital and operating expenditure forecasts as providing the most robust regulatory approach. This approach is entirely consistent with achieving the objectives of the regulatory framework, while also minimising the potential for regulatory error and the associated costs. We believe that a 'best estimate' criterion which allows the regulator to reject a reasonable estimate and substitute its own preferred value fails to acknowledge the reality that efficient costs cannot be determined with certainty and therefore, runs a considerable risk of costly regulatory error. This approach also risks a significant increase in disputation and appeals because of the difficulty in determining a 'best estimate'.